ORIGINAL

BEFORE THE ARIZONA CORPORATION CO

IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA

DOCKET NO. G-01551A-04-0876

POST-HEARING REPLY BRIEF OF SOUTHWEST GAS CORPORATION

NOVEMBER 14, 2005

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of

Post-Hearing Reply Brief

of

Southwest Gas Corporation

Docket No. G-01551A-04-0876

BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

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IN THE MATTER OF THE APPLICATION OF SOUTHWEST GAS CORPORATION FOR THE ESTABLISHMENT OF JUST AND REASONABLE RATES AND CHARGES DESIGNED TO REALIZE A REASONABLE RATE OF RETURN ON THE FAIR VALUE OF THE PROPERTIES OF SOUTHWEST GAS CORPORATION DEVOTED TO ITS OPERATIONS THROUGHOUT THE STATE OF ARIZONA.	DOCKET NO. G-01551A-04-0876

POST-HEARING REPLY BRIEF OF SOUTHWEST GAS CORPORATION

Southwest Gas Corporation ("Southwest" or the "Company") respectfully submits this Reply Brief in response to the initial closing briefs of the Arizona Corporation Commission Utilities Division Staff ("Staff") and the Residential Utility Consumer Office ("RUCO").

I.
BRIEF SUMMARY INTRODUCTION

Prominent in the briefs of both Staff and RUCO is the acknowledgment that Southwest has experienced a chronic and continuing inability to earn the Commission-authorized rate of return and that declining average customer consumption is a contributing factor. Staff states: "Staff does not deny that Southwest has not been able to earn its overall authorized rate of return ten out of the past eleven years. Staff also agrees that declining per customer usage due to increased efficiencies is a contributing factor." (Staff's Brief, p. 3, lns. 20-22.) RUCO states:

"Over at least the past 20 years, the Company has experienced a notable decrease in average consumption per customer. . . . This decreasing consumption is a major factor in SWG's difficulty in earning its authorized returns in recent years." (RUCO's Brief, p. 15, lns. 17-19.)

Unfortunately, neither Staff nor RUCO supports or advances any effective means of addressing the earnings shortfall issue. However, Southwest has, and the Commission is urged to approve in this proceeding either a rate design which minimizes reliance on consumption levels for the recovery of fixed costs, through a $0.15 tail block rate [similar to what was approved by the Nevada Commission], and/or an explicit decoupling mechanism such as the proposed Conservation Margin Tracker ("CMT") or some variation of the proposed CMT.

Regarding cost of capital, the Commission is urged to determine a cost of capital that provides an investor in Southwest with a reasonable opportunity to realize a return commensurate with the return the investor would expect to realize from an investment with corresponding risks. *Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923); *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944). There is one principle upon which the cost of capital witnesses of Southwest, Staff and RUCO all agree – i.e., the *Bluefield/Hope* standards articulated by the United States Supreme Court are the appropriate standards against which to measure whether a cost of capital recommendation is reflective of a company's <u>actual</u> capital costs.

The recommendations of any one of the cost of capital witnesses [including Southwest's Mr. Hanley and Mr. Wood], if adopted by the Commission, would result in an authorized rate of return inferior to all of the proxy groups utilized by Southwest, Staff and RUCO. The Commission is urged to adopt Southwest's recommendation and to align the interests of customers and investors by enhancing Southwest's opportunity to improve its financial profile, to the benefit of Southwest's customers in terms of improved earnings and the strengthening of Southwest's capital structure, which should result in higher credit ratings and, as a consequence, lower capital costs.

As more fully explained in this Reply Brief, Southwest contends that, as a matter of law, Southwest should be authorized to recover all operating expenses in the absence of any evidence that the operating expenses are unreasonable. *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935). A "50-50 sharing" of an expense is a disallowance of 50% of the expense and, consequently, an explicit erosion of Southwest's opportunity to realize the Commission-authorized rate of return.

The relevant inquiry is not: "Does the incurrence of the expense benefit shareholders"? Rather, the only relevant and lawful inquiry is whether the operating expense is reasonable? Inquiries regarding whether the incurrence of any particular expense benefits customers or shareholders [or both] leads down a steep slippery, confiscatory slope. If the standard were an analysis of who benefits from the operating expense, one could make an argument, based upon vague and subjective notions of equity, that every operating expense, either directly or indirectly, benefits both the shareholder and the customer.

II.
PREFATORY REMARKS

One glaring deficiency in both Staff's and RUCO's initial briefs is the lack of any legal authority cited by either party in support of their respective positions. Furthermore, there are instances where statements are made, but the statement is not supported by a citation to the record. For example, Staff claims that: "Empirically, it makes sense that economies of scale apply and that not all of Southwest's fixed costs increase at the same rate as revenues and growth." (Staff's Brief, p. 7, lns. 5-6.) Southwest submits that the record is devoid of any evidence suggesting that Southwest's fixed costs increase at the same rate as revenues and growth. Further, such a suggestion is counterintuitive to the undisputed fact that Southwest has been unable to realize its Commission-authorized rate of return during ten of the past eleven years.

As such, Southwest respectfully requests that the Judge and Commissioners consider these two noticeable deficiencies when reviewing and analyzing the briefs, the law, and the record to determine an appropriate disposition of the issues.

III.
CONSERVATION MARGIN TRACKER

A. <u>Reply to Staff's Positions</u>.

1) *The Decoupling Mechanism Proposed By Southwest Is Symmetrical.*

The decoupling mechanism proposed by Southwest is symmetrical – i.e., it would ensure recovery of the margin level authorized in this proceeding and it would shield customers from an over-recovery of authorized margin. (Gieseking Direct Testimony, pp. 18-19 and Tr. p. 357, ln. 25 and p. 358, ln. 5.) The <u>only</u> feature that one might characterize as "experimental" is the feature that would ensure, <u>for the first time</u>, that the letter and spirit of the Commission's decision in this proceeding are <u>actually</u> achieved. In fact, contrary to Staff's contention in its brief that the CMT is not similar to the PGA because the PGA recovers actual costs, Staff's CMT witness admits the two mechanisms are similar because the CMT recovers the Company's actual fixed costs. (Tr. p. 1174, lns. 7-18.)

To experiment is to "try out a new idea." (Merriam Webster's Collegiate Dictionary 409 (10th ed. 1998).) The adoption of a mechanism that explicitly decouples margin recovery from consumption levels may be a "new idea" in the context that it may be the first time for the Commission. However, the "idea" has been around for a considerable time, and it has been reviewed, considered and embraced in several jurisdictions. (*See* Southwest's Post-Hearing Brief, pp. 36 and 37, Exhibit No. A-53 and Appendix 1 to Southwest's Post-Hearing Brief.) Furthermore, attached hereto as Appendix 1 is a recent American Gas Association article that describes various decoupling methods that help prevent the erosion of Commission authorized margins that is associated with customer conservation and energy efficiency. As noted in Appendix 1, there are various types of decoupling methods and several jurisdictions have adopted mechanisms on a trial basis. (Appendix 1.) Also, as noted in Southwest's Post-Hearing Brief, this Commission, in a rulemaking proceeding 14 years ago, explicitly deferred for consideration in future rate cases the issue of decoupling revenue recovery from consumption. (*See* Southwest's Post-Hearing Brief, p. 37 and Commission Decision No. 57589, 128 P.U.R 4th 448, 1981 WL 137969 (Ariz. C.C. 1981).)

It is apparent from the record that Staff's opening volley on CMT [i.e., "Southwest proposes an experimental mechanism"] is without merit in the ordinary sense of the word "experimental." However, whether Southwest's proposal is characterized as experimental or not, if an explicit decoupling mechanism addresses the chronic and continuing earnings shortfall issue facing Southwest, then it should be considered. In opposing the CMT proposal, Staff argues that, <u>if</u> [which only suggests that it <u>might</u> happen] the decline in average customer consumption were to decelerate, Southwest would have a better opportunity to achieve its authorized rate of return. (Staff's Brief, p. 5, lns. 8-15.) If Staff's hypothetical were to become reality, then the CMT surcharge, if any, would be correspondingly lower. Query: What harm, then, would there be to having the mechanism in place? Southwest submits that not only would there be no harm, but that the customer benefits by having the protection of the CMT because the Company is prevented from collecting more than the Commission-authorized margin. (Gieseking Direct Testimony, pp. 18-19 and Tr. p. 357, ln. 25 and p. 358, ln. 5.)

2) ***Southwest Presented Evidence That Declining Average Residential Usage Is the Predominant Reason Southwest Has Been Unable To Achieve Its Overall Authorized Rate of Return.***

Staff states that it is "not convinced" that declining average residential usage is the "predominant reason" for Southwest's inability to achieve its overall authorized rate of return. (Staff's Brief, p. 3.) Southwest suggests that Exhibit No. A-32 (RAM-1), Sheets 4 and 5 are quite convincing! A further review of the evidence demonstrates that, during the eleven (11) year period prior to the end of the test year, over 50% of the earnings shortfall is directly attributable to declining average residential usage. [*See* Mashas Direct Testimony, Exhibit RAM-1, Sheet 6, which illustrates that $145,590,650 is the aggregate earnings shortfall and Lines Nos. 8 through 18 on Sheets 4 and 5 of Exhibit RAM-1, which illustrates that, in total, $73.1 million is attributable to unrealized margin due to declining average residential consumption.][1] Moreover, contrary to Staff's assertions, Southwest never claimed that declining use was the sole cause and the Company presented uncontradicted evidence that it is the predominant contributing factor.

[1] Mashas Direct Testimony, Exhibit RAM-1, Sheets 4 and 5, also demonstrates that, from the period 1987 through the end of the test year, the total margin shortfall due solely to declining average residential usage was $122.4 million.

3) *A Decoupling Mechanism Will Not Create a Disincentive To Conserve.*

A decoupling mechanism such as the CMT will not create a disincentive to conserve for the reason that the more a customer conserves the more a customer saves. (Gieseking Rejoinder Testimony, pp. 8-9 and Tr. pp. 417-418.)

Stepping back from the rhetoric, Southwest directs attention to Exhibit No. A-49 (a courtesy copy is included herewith in Appendix 2). The exhibit illustrates how the CMT would be applied under two scenarios: (1) one, in which a customer does not conserve [Years One and Two] and (2) the other, in which a customer does conserve in Years One and Two [assuming an annual consumption reduction of twenty (20) therms]. As reflected on lines 9 and 10, the customer who does not conserve would have no savings and would pay a CMT surcharge of $2.57 annually;[2] the customer who does conserve would have annual savings totaling $33.57 after paying a CMT surcharge of $2.43. The exhibit illustrates that, under the CMT, both customers have a strong incentive to conserve. If the customer who does not conserve continues the same pattern, the customer will continue to have no savings and continues to pay a higher CMT surcharge; and, if the customer who does conserve continues the same pattern, the customer continues to save and continues to pay a lower CMT surcharge.

Exhibit No. A-49 also reflects that, under the 20-therm reduced therm usage example, the amount of the CMT surcharge is very minimal [e.g., approximately 20 cents per month for each customer]; however, without the CMT, the margin deficiency would total $2,180,000 [872,000 customers at August 31, 2004 – *see* line 22 on page 7 of Palacios Direct Testimony – times $2.50

[2]Staff mistakenly calculates the annual surcharge to be $24.29. (*See* Staff's Brief, p. 8, lns. 8-10.) The mistake was made by using a 7 cent/therm CMT surcharge instead of the .742 cent/therm CMT surcharge reflected on Exhibit No. A-49.

(the approximate annual CMT surcharge per customer)]. The impact on an individual customer would be relatively insignificant; however the impact on the Company's ability to realize the revenue requirement authorized by the Commission in this case would be very significant.

If fear of the unknown [i.e., how high might the CMT surcharge be under unpredictable scenarios][3] is a perceived barrier to Commission adoption of the proposed CMT, Southwest urges Judge Nodes and the Commissioners to consider capping the authorized surcharge in relation to a maximum annual 20 therm reduction in average residential consumption. Under such a cap, the maximum impact of the CMT surcharge is captured in Exhibit No. A-49.

One of the reasons urged by Staff to reject the CMT proposal is the fact that, in Southwest's last general rate case before the Public Utilities Commission of Nevada, Southwest's proposed decoupling mechanism was not approved. Unfortunately, Staff cherry-picks a portion of the Nevada Commission's Order (i.e., Exhibit No. S-22, ¶ 285) and ignores the very next paragraph and other significant portions of the Order, in which the Nevada Commission noted:

> In this Order, the Commission is choosing alternative methods to assist with stable earnings such as the hypothetical capital structure, the variable interest rate recovery mechanism, the increase to the basic customer charge, its encouragement to use more frequent rate filings with certifications for updating information as necessary, and the overall rate design.

Regarding the overall rate design, the Nevada Commission stated as follows:

> The Commission recognizes that Southwest is experiencing problems achieving revenue and income stability due to declining average residential customer usage, and that Southwest's declining block rates are designed to help correct these problems. The Commission also believes that Staff's proposed minor modifications to capture Southwest's percent usage in both summer and

[3]Staff witness Musgrove expressed concern that the proposed mechanism would be flying without a licensed pilot. (Tr. p. 1144, lns. 8-9.)

> winter periods are appropriate and encapsulate Southwest's same rate design, which recovers a significant portion of its fixed costs in the first block. Therefore, the Commission finds Staff's declining block rates contained in Paragraphs 309 and 310 above are just and reasonable and approved. (Exhibit No. S-22, ¶ 314.)

Although the Nevada Commission did not approve a decoupling mechanism, it did order Southwest to file in its next general rate case a weather normalization plan to help address its revenue volatility issues and the Nevada Commission approved a tiered volumetric rate structure similar to Southwest's proposal in this proceeding [without the CMT]. The Nevada rate design also provides for a tail block rate of approximately $0.15. (*See* Southwest's Statement of Rates for its Nevada jurisdiction, a courtesy copy is included herewith in Appendix 3.) Thus, the Nevada rate design only places approximately $0.15 of margin at risk of non-recovery in the event of any potential decreased consumption by Southwest's customers. In comparison, RUCO proposes a tail block rate of approximately $0.49 and Staff proposes a tail block rate of approximately $0.50. (Exhibit A-51.) As such, while the Company is faced with continued declining residential consumption, both Staff and RUCO have proposed tail block rates that will only exacerbate the Company's ability to earn its Commission-authorized margin.

B. <u>Reply to RUCO's Positions</u>.

1) *RUCO Agrees That the Commission Ought To Modify Southwest's Existing Rate Design.*

RUCO agrees that the Commission ought to modify Southwest's existing rate design in recognition of the fact that its margins are at risk if consumption continues to decrease. (RUCO Brief, p. 16, lns. 10-11.) Nonetheless, RUCO recommends that the CMT not be approved.

None of the following reasons cited by RUCO for rejecting the proposed CMT has merit:

1. RUCO states that the CMT approach is contrary to the Commission's historic

approach in setting rates and, yet, RUCO states that the Commission "ought to modify" the historic approach taken with respect to Southwest. (RUCO's Brief, p. 15, lns. 15-16.)

2. RUCO states that the CMT would provide Southwest with greater assurances of revenue recovery than the Commission usually affords and, yet, RUCO states that the Commission "ought to modify" the historic approach in recognition of the fact that Southwest's margins are at risk if consumption continues to decrease. (RUCO's Brief, p. 16, lns. 21-22.) Contrary to the implications that have been made by both Staff and RUCO, there is nothing wrong with providing Southwest greater assurance of recovering its Commission-authorized margin. Commission-authorized margin is different from the Commission-authorized rate of return, and one should not lose sight of this difference. A rate design is supposed to permit the Company to recover its Commission-authorized margin. *Scates v. Arizona Corporation Commission,* 118 Ariz. 531, 578 P.2d 612 (1978); *see also, Peoples Organization for Washington Energy Resources v. Washington Utilities and Transportation Commission,* 711 P.2d 319 (Wash. 1985). Once the revenue requirement is established by the Commission, rates [and a rate design] must be established to permit the recovery of the Commission-authorized revenue requirement; anything less is confiscatory. (*Id.*)

3. RUCO states that the "decreasing consumption" problem "is likely to be slowing" and, yet, RUCO states that the Commission "ought to modify" the historic approach taken with respect to Southwest. (RUCO's Brief, p. 17, lns. 8-9.) As noted above in this Reply Brief, there is no harm placed on Southwest's customers if it turns out that the CMT is more and more unnecessary due to any potential deceleration of the decline in consumption. This is because there would be no surcharge to customers or there would be a surcredit to customers and

protection from an over-recovery of authorized margin by the Company.

4. RUCO states that the CMT would have "imbalanced impacts on customers." (RUCO's Brief, p. 17, lns. 13-16.) As Southwest already has indicated, Southwest has no objection to having the CMT applicable to classes of customers other than the residential class. (Tr. p. 376, lns. 16-23.) In that regard, Southwest would propose the CMT be applicable to all customer classes that are subject to the PGA – as Staff states in its initial opening brief, "The CMT is essentially another adjustor mechanism." (RUCO's Brief, p. 3, ln. 28.) To the extent that RUCO's "imbalance" argument relates to individual customers, attention is directed to Exhibit No. A-49, which demonstrates how insignificant the application of the CMT is when comparing the customer who conserves with the customer who does not conserve. (RUCO's Brief, p. 19, lns. 13-14.)

5. RUCO states that the proposed CMT is an excessive modification to Southwest's existing rate design and, yet, RUCO states that the Commission "ought to modify" the historic approach. (RUCO's Brief, p. 18, lns. 17-18.) Monthly bills would be rendered independent of the CMT mechanism, except insofar as a surcharge or surcredit would be included to "true up" for any deviation from the Commission "authorized margin per customer" experienced in a prior year.

Despite RUCO's claim that the existing rate design should be modified, it rejects the CMT and fails to provide any meritorious reasons in support of their position, and RUCO fails to provide any alternative decoupling mechanism proposals to address a problem recognized by it and Staff.

IV.
RATE DESIGN

A. <u>The Commission Ought To Modify Southwest's Existing Rate Design in Recognition of the Fact That Southwest's Margins Are at Risk If Consumption Continues To Decrease</u>.

Those are the exact words of RUCO. (RUCO's Brief, p. 16, lns. 10-11.) Moreover, it is difficult to imagine that anyone following the hearing would not intuitively come to the same conclusion. Both Staff and RUCO agree that Southwest's rate design proposal would provide the greatest degree of revenue and bill stability among the three parties' proposals. (Tr. p. 1001, lns. 18-20 and p. 1231, lns. 11-21.) However, notwithstanding the rhetoric, both Staff and RUCO are doing nothing more than what they have done historically. That is, proposing rate designs that slightly shift a portion of the authorized margin into the basic service charge and loading the remaining margin into the volumetric charge. (Gray Direct Testimony, p. 35, lns. 19-26 and Moore Surrebuttal Testimony, Schedule SUR-RLM-16.) Even more puzzling is both parties are increasing the tail block commodity rate from the current rate, thus frustrating any meaningful improvement in the recovery of fixed costs that may have occurred due to the increase in the basic service charge. (Exhibit A-51.) Exhibit A-51 demonstrates the negative impact of Staff's and RUCO's increase from the current tail block rate of approximately $0.40 to approximately $0.50 and $0.49, respectively. (*Id.*) RUCO's and Staff's proposals put Southwest at greater risk of not recovering its authorized margin due to the associated risk of relying upon consumption levels to recover authorized margin. (*Id.*) Especially in light of the overwhelming evidence of declining residential use per customer and the proposals to increase conservation and energy efficiency programs by nearly four and one-half million dollars.

It is axiomatic that, so long as any portion of fixed cost recovery is dependent on consumption levels, there is a risk that the fixed costs will either be under-recovered or over-recovered.

Conservation and energy efficiency are laudable goals, and Southwest supports them. (Shaw Direct Testimony, p. 8.) However, having a customer help to conserve the resource, natural gas, is one thing, and having a customer avoid paying for Southwest's fixed costs is another. The latter does something much different than merely conserve the resource – i.e., it encourages conservation at the expense of the Company by inequitably eroding Southwest's opportunity to recover Commission-authorized margin. This approach is unnecessary when there are other available methods of encouraging conservation without inequitably eroding the Company's opportunity to recover the Commission-authorized margin, i.e., the CMT or some other form of decoupling margin recovery from consumption levels.

Staff incorrectly asserts that Southwest's rate design proposals do not consider affordability. (Staff's Brief, p. 11, lns. 14-15.) To the contrary, Company witness Brooks Congdon presented extensive evidence and analysis of why Southwest's rate design proposals address the issue of customer impact and affordability. Mr. Congdon explained that the Company's rate design proposals consider affordability by recognizing that low volume customers are more able to afford a $4 to $8 increase in their bills than large volume customers [including low income customers] are able to afford a $30-$40 increase in their bills. (Congdon Rejoinder Exhibit ABC-1 and Tr. pp. 221 and 231-232.) This is another example of why Southwest's rate design proposals address customer impact and affordability better than Staff's or RUCO's rate design proposals.

Staff's criticism of Southwest's rate design proposals and Southwest's reduction of the subsidy that large volume customers provide low volume customers, incorrectly implies that large volume customers are somehow wasteful and are not concerned with energy efficiency. (Staff's Brief, p. 11.) To the contrary, each individual customer has different uses and may require different volumes of gas each month. As Mr. Congdon explained during the hearing, single professionals living in new, modern, highly efficient houses likely use less gas than a large residential family with a stay at home mother who is taking care of children, doing laundry, taking more showers, etc. (Tr. pp. 291-293.) Furthermore, Staff has presented no evidence to demonstrate that higher levels of natural gas usage are necessarily wasteful. As such, concluding that high volume usage somehow equates to wasting natural gas is simply speculative and unfounded.

Furthermore, Staff continues to imply that low use equates to low income by asserting that the Company's rate design proposals will impact low income customers greater than Staff's rate design proposal. (Staff's Brief, p. 13, lns. 1-3.) However, Staff fails to support this remark with any citation to the record. (Staff's Brief p. 12, ln. 22 and p. 13, ln. 2.) To the contrary, Southwest presents uncontradicted evidence that the relationship between Southwest's low income customers and its other residential customers is remarkably similar. (Exhibit A-50.) (A courtesy copy is included herewith in Appendix 4.) As noted above, Southwest's rate design addresses affordability by reducing the impact on large volume customers [including low income customers, those that need the most assistance], and by moving to reduce the subsidy to low volume customers that is currently provided by large volume customers.

Staff and RUCO both contend that maintaining the declining block rate structure is counterintuitive to the goal of promoting energy efficient consumption because a high volume customer purportedly receives a price break because the customer's consumption falls into a reduced second tier. (Staff's Brief, p. 11, lns. 8-11 and RUCO's Brief, p. 20, lns. 4-5.) This contention is misleading. There is a fundamental difference between the gas cost and the margin component of rates. All purchased gas adjustment ("PGA") customers pay the same gas cost and, contrary to Staff's contention, a customer who uses more gas is actually paying a larger portion towards the Company's recovery of its margin than a customer who uses less gas. This is because large volume customers are subsidizing the small volume customers, which is a consequence of not moving toward cost of service based rates and not front loading the Company's recovery of authorized margin in the basic service charge and in the first tier of a volumetric rate design. (Tr. pp. 223-226.)

There is an impressive menu of rate design options before the Judge and the Commissioners, and the rate design options would be much more readily and fairly addressed, if an explicit decoupling mechanism were adopted. With a decoupling mechanism, authorized margin levels would be realized, customers would be protected against an over-recovery of margin and everyone could go about the business of enthusiastically conserving the resource – without harm to any of the affected interests.

Southwest is seeking a reasonable opportunity to actually realize the margin level authorized by the Commission – nothing more and nothing less. The record is replete with all of the reasons why realizing the Commission-authorized margin would align with the best interests of Southwest's customers. With improved earnings, Southwest's capital structure would be strengthened which should result in higher credit ratings and, as a consequence, lower capital costs. (Wood Rebuttal Testimony, p. 9, ln. 23 through p. 10, ln. 11.) It truly can be said that realization of the Commission-authorized margin level would be a win-win result.

B. Billing Determinants.

In addition to the arguments presented by Southwest in its Post-Hearing Brief, and contrary to RUCO's claim, Southwest provided RUCO with information sufficient for RUCO to verify that the billing determinants actually produce the test year recorded revenue. (Congdon Rebuttal Testimony, pp. 24-25 and Congdon Rebuttal Testimony, Exhibit ABC-4.)

C. Four Hour Service Window.

In addition to the arguments already presented by the Company on pages 66-67 of its Post-Hearing Brief, there is simply no justification in the record to support the implementation of Staff's recommendation. There is no evidence that justifies such a drastic change in the Company's service options, especially in light of the fact there is admittedly only a small number of customers out of the nearly quarter of a million annual service calls that the Company receives that have purportedly even expressed a concern. (Tr. pp. 106-07 and 1243-44.) Furthermore, the only evidence of record is that Staff's proposal will likely require new software and additional employees to implement, costs that have not been added to the Company's requested cost of service in this proceeding and can be expected to further impair the Company's ability to realize the Commission-authorized margin in this case. (Palacios Rejoinder Testimony, p. 6.) As such, notwithstanding this lack of justification, if the Judge and Commissioners are not inclined to reject the recommendation, the most that should be ordered is that the Company perform a cost-benefit study to determine whether the costs to implement such a practice are justified.

D. **Purchased Gas Adjustor**.

As noted by Southwest in its Post-Hearing Brief, the Company is recommending a suspension of the $0.10 per therm band in the PGA adjustment rate or, in the alternative, an increase in the band to $0.20 per therm. (Gieseking Rejoinder Testimony, pp. 10-11.) As such, Southwest is opposed to Staff's recommendation to retain the $0.10 per therm band. However, to the extent there is not a temporary suspension of the per therm band, Southwest does not object to the recommendations of Staff regarding the setting of a benchmark if the Commission sets the base cost of gas to zero. (Gray Direct Testimony, pp. 15-16.)

E. **Bill Format**.

Staff incorrectly states that Southwest's opposition to its recommendation to add a place on the customer's bill for donating money to the Energy Share program has been dropped. (Staff's Brief, p. 15, ln. 24 through p. 16, ln. 1.) As explained by Mr. Congdon and as presented by the Company in its Post-Hearing Brief, the Company opposes this recommendation on grounds that there are incremental costs associated with implementing such a recommendation that are not included in the revenue requirement in this proceeding. (Southwest's Brief, p. 69.)

The Company's opposition on this issue should not be perceived as a lack of support of the program. To the contrary, as noted by Staff, the Company presently participates in the Energy Share program and notifies its customers of the opportunity to participate in the program via a bill insert with an information card that customers can fill out identifying whether they intend to participate in the program, and providing them an opportunity to designate the amount they wish to donate, either monthly or in the form of a lump sum donation. (Gray Direct Testimony, p. 55.) Southwest opposes this recommendation because it is concerned about incurring incremental costs without some assurance that any potential benefit will exceed the incremental cost. Please refer to the Company's Post-Hearing Brief, pp. 68-69 for further argument on this issue.

V.
COST OF CAPITAL

A. Reply to Staff's Positions.

1) ***Staff's Proposed Cost of Capital Estimate Will Not Permit an Investor in Southwest To Realize a Return Commensurate With a Return on an Investment in Staff's Proxy Group Companies.***

Staff witness Hill answered "no," when asked whether, under Mr. Hill's proposed cost of capital estimate, an investor in Southwest could expect to realize a return commensurate with a return on an investment in the proxy group companies. (Tr. p. 898, lns. 8-11.) Exhibit No. A-41 illustrates the comparison between Mr. Hill's recommendation and the experience of Mr. Hill's proxy group. Essentially, without explicitly acknowledging the fact, Mr. Hill admits that his recommendation does not align with the *Bluefield/Hope* standards – i.e., it does not provide an investor in Southwest with an opportunity to realize a return commensurate with the return the investor could expect to realize from an investment having corresponding risks. (Tr. p. 898, ln. 8 through p. 899, ln. 6.) Under cross-examination, Mr. Hill testified that the "Achieved ROE" of 10.93% illustrated on Exhibit No. A-41 is a historical number which is not reflective of the investor's current expectation. (Tr. p. 898, lns. 16-22.) However, the evidence of record is to the contrary. Attachment A to Exhibit No. RUCO-1, a June 17, 2005 Value Line publication pertaining to composite statistics for natural gas distribution companies, indicates that the investor expectation for a return on common equity for 2005 and 2006 is 12% and, for years 2008-2010, the investor expectation is 12.5%.

Mr. Hill interjects a desultory position that, with a hypothetical capital structure reflecting a greater common equity component than Southwest's actual common equity component, Southwest's customers would be paying for equity that does not exist and, that, Southwest's customers would be providing a financial subsidy. (Tr. p. 873, ln. 24 through p. 875, ln. 1.) Mr. Hill misses the point. The reason for utilizing a hypothetical capital structure for Southwest is "to adjust for the risk differential" between Southwest and a proxy group. (Tr. p. 847, lns. 7-16.) In fact, Mr. Rigsby conceded that, in the context of adjusting for the risk differential, it would be reasonable to utilize the proxy group's 49.85% common equity component instead of the 42% recommended by both Southwest and RUCO. (Tr. p. 848, ln. 23 through p. 849, ln. 5.)

Moreover, Staff continues to refer to the recent Arkansas Public Service Commission order for the gas utility Centerpoint Energy Arkla, Docket No. 04-121-U as support for a low cost of common equity. (Staff Brief, p. 32.) However, Staff ignores the fact that the Arkansas Commission also approved a hypothetical capital structure based upon the proxy group average capital structure of eight similar risk LDCs consisting of 45.64% common equity ratio, in lieu of Arkla's actual common equity component of 38.56%. (Exhibit S-20, p. 49 and Appendix 5.)[4] Accordingly, when you step out of the vacuum in which Staff wants to view the Arkansas decision, the low cost of common equity was clearly impacted by the hypothetical capital structure and common equity ratio of 45.64%. Furthermore, this decision should be given no more weight than the sixty-two other fully litigated cases referred to by Company witness Frank Hanley in his analysis in FJH-24. (Hanley Rebuttal Testimony, Exhibit FJH-24.)

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[4] For the convenience of the parties, Appendix 5 contains the pertinent pages of Johnny Brown's direct and surrebuttal testimony, and the applicable exhibits. The Arkansas Commission adopted Mr. Brown's proposed hypothetical capital structure and common equity ratio of 45.64% that was the proxy group average capital structure of eight similar risk LDCs.

Mr. Hill's posturing is totally undermined, not only by comparing his end result with reality, but also by observing his apparent view of the *Bluefield/Hope* standards. During cross-examination (Tr. p. 890, lns. 4-7), Mr. Hill insisted that the following statement in his direct testimony accurately captures the letter and spirit of the *Bluefield/Hope* standards:

> "Therefore, the equity return I recommend fulfills the regulatory requirement that the regulated firm be allowed a return that will afford the Company an opportunity to maintain its credit and attract capital." (Hill Direct Testimony, p. 4, lns. 9-11.)

Accordingly, maintaining a credit rating on the cusp of junk bond status [and still being able to raise capital, presumably at any cost] is Mr. Hill's view of the *Bluefield/Hope* standards. Even Mr. Hill conceded during cross-examination that, given Staff's stated mission of balancing the interests of all stakeholders, it is "ironic that the balanced approach would undercut" the recommendation of RUCO. (Tr. p. 889, lns. 18-22.)

Appendices 6 and 7 illustrate how Mr. Hill's ultimate cost of capital recommendation, as well as his distorted approach to the entire subject of estimating Southwest's cost of capital, fall outside the zone of reasonableness and, accordingly, his recommended 9.5% equity return with a 40% common equity component in the hypothetical capital structure should be rejected.[5] By peering out the window instead of becoming buried in the dark with model results, the reality is that Mr. Hill's estimated cost of equity for Southwest of 9.5% with a 40% common equity component in the capital structure is woefully low -- if the objective is to satisfy the *Bluefield/Hope* standards of reasonableness. Southwest urges the Judge and the Commissioners to reject the Hill-stated objective of barely keeping Southwest afloat.

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[5] Appendices 6 and 7 are graphic representations of the data referred to by Frank Hanley in his Rebuttal Testimony, Exhibit FJH-24.

B. Reply to RUCO's Positions.

1) *RUCO's Recommendation Is Woefully Inadequate in Comparison to RUCO's Own Proxy Groups.*

The 5-year [2000-2004] average common equity ratio among RUCO's proxy group was 49.85% and the average earned return on common equity during the same period for the same proxy group was 11.88%. (Wood Rebuttal Testimony, Exhibit Nos. TKW-1 and TKW-4, Sheet 2.) RUCO's estimated cost of equity for Southwest of 10.39% [without a CMT] with a 40% common equity component in the capital structure is woefully low – if the objective is to satisfy the *Bluefield/Hope* standards – as opposed to the Hill-stated objective of barely keeping Southwest afloat.

On page 12 of RUCO's brief, RUCO incorrectly states that the Company chose the proxy companies with the five highest ***regulatory awarded*** returns on equity to arrive at its final recommendations. To the contrary, Mr. Hanley explains that, as shown in Exhibit FJH-13, the lowest regulatory awarded return on equity was 9.90%, thus he **"eliminated indicated DCF cost rates of 9.9% or lower from consideration as they are not indicative of any reasonable expected common equity cost rate."** (Emphasis added.) (Hanley Direct Testimony, Exhibit A-38, p. 32.) He did not simply choose the five highest returns on equity to arrive at his final recommendation. Furthermore, this establishment of a floor was not arbitrary, but based upon Mr. Hanley's expert judgment. (*Id.*)

On pages 71 through 84 of Southwest's Post-Hearing Brief, the subject of cost of capital is thoroughly addressed and, rather than engage in a wholesale repetition, reference is made to that portion of Southwest's brief.

VI.
REVENUE REQUIREMENTS

With the exception of the expenses associated with deferred income taxes and the Management Incentive Plan ("MIP"), with respect to which both Staff and RUCO take issue, there is no other issue associated with revenue requirements that is shared by both Staff and RUCO. Accordingly, Staff's and RUCO's issues are addressed separately, except for deferred income taxes and MIP.

A. Reply to Staff's Positions.

The transmission integrity management program ("TRIMP") and the compliance costs associated with Sarbanes-Oxley ("SOX") are both federally-mandated, yet, Staff proposes a disallowance of both [i.e., a "sharing"]. (Staff's Brief, pp. 23-25.) A disallowance of any of the associated costs would be confiscatory and, as a consequence, an explicit erosion of Southwest's opportunity to realize the Commission-authorized rate of return.

Staff urges a disallowance of TRIMP costs [which is termed a "sharing" by Staff] even though "Staff recognizes the importance and necessity" of the costs. (*See* lines 14-15 on page 23 of Staff's Initial Closing Brief.) On none of the "sharing" issues does Staff share with the Judge, the Commissioners and the other parties any legal basis for such an approach. Southwest addressed in detail in its Post-Hearing Brief the legal issues associated with denying Southwest the opportunity to recover 100% of its reasonable, ongoing operating expenses. As evidenced from Southwest's Post-Hearing Brief, the proper standard is whether the operating expense is reasonable. *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935).

Southwest does not doubt that Staff may cite several commission level decisions, from various jurisdictions [including this Commission], that have entertained and adopted arguments that either costs should be shared or that have undertaken an analysis of who benefits from the expense. However, when this issue has been challenged at the district court level, the majority of district courts that have addressed this issue have rejected the sharing argument and any associated analysis of who benefits from the expense. *Butler Township Water Company v. Pennsylvania Public Utility Commission*, 473 A.2d 219 (Pa. Cmw. Ct. 1984) (where court rejected argument that rate case expenses benefit both the shareholder and the ratepayer and that both should bear a portion of these costs on grounds that the public utility is entitled to recover prudently incurred expenses); *Citizens Utility Board v. Illinois Commerce Commission*, 651 N.E.2d 1089 (Ill. 1995) (where court rejected argument that coal tar cleanup costs should not be included in utility rates because the costs do not provide a direct benefit to current utility customers); and *Petition of New Jersey American Water Company, Inc. for an Increase in Rates for Water and Sewer Service and Other Tariff Modifications,* 777 A.2d 46 (N.J. 2001) (where court rejected argument that charitable contributions should be shared 50/50 because the costs benefit both ratepayers and shareholders).

As stated at the outset of this Reply Brief, the only relevant question, when it comes to an item of expense, is whether the operating expense is reasonable. *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935). Staff admits that the TRIMP and SOX expenses will actually be incurred and that they are reasonable. (Tr. p. 1085, ln. 25; p. 1086, ln. 7; and p. 1087, lns. 15-20.) Accordingly, Staff's proposed disallowance should be rejected.

B. Reply to RUCO's Positions.

RUCO's proposed disallowances of the total compensation of 37 employees , post-test year wage increases and supplemental executive retirement plan ("SERP") costs are a re-hash of positions taken by RUCO and rejected by the Commission in Southwest's last general rate case – i.e., Decision No. 64172. Independent of that fact, the issues associated with RUCO's proposed disallowances are discussed at length in Southwest's Post-Hearing Brief. (*See* pages 94-96, 98-99 and 102-103.)

Regarding dues paid to the American Gas Association ("AGA"), RUCO proposes a disallowance of a portion of the dues related to Communications and Public Affairs. First, Southwest already removed from the cost of service AGA's market development cost center and, second, RUCO has not presented any evidence suggesting that Southwest's reliance on the AGA's cost center descriptions for determining what cost centers are appropriate for recovery in rates is unfounded or improvident. Accordingly, RUCO's proposed disallowance should be rejected.

Regarding Miscellaneous Expenses, RUCO continues to ignore the Company's rebuttal testimony and, consequently, RUCO's brief is not representative of the evidence of record. (RUCO Brief, p. 10.) As reflected in Southwest's Post-Hearing Brief, Southwest exhaustively addressed RUCO's concerns regarding the reasonableness of expenses identified in a response to a RUCO data request and, in fact, Southwest voluntarily removed expenses totaling $62,165 after a more thorough review of the questioned expenses. (Aldridge Rebuttal Testimony, p. 16, ln. 5 through p. 17, ln. 3 and Aldridge Rebuttal Testimony, Exhibit RLA-5.) RUCO's continued opposition to the Company's revised request is devoid of any evidentiary basis other than its reliance on stale information, and its reliance upon suspicion or speculation.

C. Southwest's Deferred Income Taxes Adjustment is Warranted.

Southwest's proposed [post-test year] rate base adjustment for deferred income taxes [due to an August 2005 revenue ruling] is consistent with Staff's and RUCO's proposal for a property tax expense adjustment due to legislation effective post-test year.

Independent of the arguments and analysis presented by Southwest in its Post-Hearing Brief, Staff's and RUCO's arguments in opposition to this adjustment must fail for the following reasons:

i) If, as Staff and RUCO argue, the recognition of the recent changes in law pertaining to property taxes is proper because they are known and measurable, then the deferred tax adjustment is also proper because it is also known and measurable. (Staff's Brief, p. 25; Tr. p. 486, lns. 16-23 and p. 500, lns. 20-23; and RUCO Brief, p. 5, lns. 12-14.) Southwest presented uncontradicted evidence that this adjustment is known and measurable and that it has made a journal entry reflecting this change in law. (Tr. p. 497, lns. 21-23.)

ii) Staff's argument that the deferred tax adjustment is not known and measurable because the effects of the 2005 Energy Policy Act are not yet known must fail because the 2005 Energy Policy Act does not pertain to any of the plant in Southwest's test year rate base; whereas, the deferred income tax adjustment applies to plant within the Company's test year rate base. (Staff Brief, p. 26 and Tr. p 493, ln. 10 through p. 494, ln. 23.)

iii) Staff's argument that the deferred income tax adjustment is not proper because the

Company has not made a tax payment must fail because the Company has yet to make property tax payments that reflect the change in law that Staff supports because one of those changes does not become effective until January 2006. (Staff Brief, p. 26.)

iv) RUCO's argument that the deferred income tax adjustment is not proper because the change in law is a temporary regulation that may change must fail because temporary regulations have the full force and effect of final regulations, and any potential change will not change the effect of the regulation. (RUCO Brief, p. 5, lns. 8-12 and Tr. p. 492, lns. 4-5.)

v) RUCO's argument that the deferred income tax adjustment is not proper because it was not in the Company's original application must fail because neither were the effects of the recent changes in property tax law. (RUCO Brief, p. 6 and Tr. p. 485, n. 23 through p. 486, ln. 11.) Moreover, after RUCO was served with the rebuttal testimony of Lisa Moses, providing notice of the Company's revised request in light of the revenue ruling and regulation change, RUCO could have served data requests and filed surrebuttal testimony in opposition to Southwest's request. However, RUCO chose not to.

Essentially, Staff wants to cherry-pick post-test year changes that only result in a reduction in the revenue requirement. Southwest simply requests a fair and balanced approach to seizing post-test year adjustment opportunities. As such, the deferred income tax adjustment is warranted.

D. Recovery of the Management Incentive Plan in Southwest's Cost of Service is Proper.

Participants in the Management Incentive Plan ("MIP") have a portion of their total compensation at risk, and there is no evidence that the total compensation of any participant is unreasonable. In many quarters, the MIP is routinely opposed because it is viewed, and often characterized, as some crude "bonus" program. However, in reality, it is a program that is intended to incentivize the participants to attain certain stated objectives related to customer satisfaction, productivity and profitability, and to retain quality management. (Mashas Rebuttal Testimony, pp. 6-11; Exhibit 52; and Tr. pp. 66-74.)

Staff and RUCO propose partial disallowances of the MIP expense based on some notion that a portion of the expenses benefit shareholders. (RUCO's Brief, p. 8, lns. 8-9 and Staff's Brief, p. 23, lns. 1-2.) As observed above, a "sharing" of an expense is a partial disallowance of the expense and, if a reasonable, ongoing operating expense is disallowed, there is an explicit erosion of Southwest's opportunity to realize the Commission-authorized rate of return. Sharing is not the test for whether an item of expense should be recognized for ratemaking purposes. *Scates v. Arizona Corporation Commission*, 118 Ariz. 531, 578 P.2d 612 (1978); *West Ohio Gas Company v. Public Utility Commission of Ohio*, 294 U.S. 63 (1935). The test is whether the expense is reasonable and ongoing. (*Id.*) The MIP expenses <u>are</u>. (Tr. p. 1093, lns. 9-11.)

The view expressed by RUCO is that shareholders are the primary beneficiaries of the MIP, since two of the five performance targets are related to the achieved return on equity, and the incentive to reach those two targets should be borne – at least in part, if not in total, by the shareholders. (RUCO's Brief, p. 8, lns. 23-24.) The abstract rhetoric ignores reality. Subsumed in the revenue requirement determined in this proceeding is the cost of equity. Actually earning the cost of equity allowed by the Commission is not a <u>bonus</u> for the shareholders – it simply means that the Commission-allowed cost is actually realized. Unless and until Southwest over-earns [i.e., earns more than authorized by the Commission], there is no discrete shareholder benefit. Viewed more dramatically, the shareholder is actually punished unless and until Southwest realizes 100% of the costs [including the cost of equity] allowed by the Commission.

If one were to follow the logic that the shareholders benefit when the MIP participants strive to achieve a performance target associated with the return on equity, then every dollar Southwest realizes benefits the shareholder because it is one more dollar toward achieving the target – even though Southwest is not recovering fully the <u>cost</u> allowed by the Commission. The logic is flawed and the result of applying it is wrong.

Staff acknowledges that the MIP is reasonable. (Tr. p. 1093, lns. 9-11.) Furthermore, since no party challenges the total compensation of these management employees, Southwest is actually being penalized by placing a portion of the management's compensation at risk. If the MIP portion of the total compensation were included in the base salary of these employees, Staff and RUCO would have no argument to disallow any portion of the total compensation. As such, the Judge and the Commissioners should not fall prey to the proposed disallowance of a reasonable operating expense simply because the compensation is structured in a manner that has prompted Staff and RUCO to propose a disallowance.

It bears repeating, because it applies to all of the disallowances proposed by Staff and RUCO in this proceeding. Everything else remaining constant, the <u>only</u> way Southwest can possibly earn its authorized rate of return is if Southwest recovers <u>all</u> of its reasonable, ongoing operating costs. The corollary is that, if any reasonable, ongoing operating costs are disallowed, then realizing the Commission-authorized rate of return is most likely impossible.

VII.
UNCONTESTED ITEMS

In addition to the uncontested items listed in Southwest's Post-Hearing Brief, there were some items that were inadvertently excluded from that list and one item that needs to be clarified in light of Company witness William Moody's corrections to his rejoinder testimony that he identified at the hearing. They are as follows:

1. **Low Income Residential Gas Service – Schedule G-10.**

   a. Southwest accepts Staff's proposal to begin adding, for its Low Income Rate Assistance report, a complete accounting for the LIRA bank balance for the most recent 12 month period, within 90 days of the date of the final order in this proceeding. (Gray Direct Testimony, p. 41.)

2. **Customer Deposits.**

   a. Southwest accepts Staff's proposal to maintain the current 12 month provision pertaining to the retention of customer deposits. (Gray Direct Testimony, p. 56.)

3. **Purchased Gas Adjustor.**

   a. Southwest accepts Staff's proposal to list purchases in the PGA report into groups of fixed price contracts and other contracts that vary, such as index contracts. (Gray Direct Testimony, p. 25.) Southwest also accepts Staff's proposal to specifically identify in the monthly PGA report what the average and median usage levels are for the G-5 and G-10 schedules for that given month. (*Id.*)

4. **Low Income Rate Assistance.**

   a. Southwest accepts Staff's interpretation of the Company's tariff regarding the federal poverty income level, and agrees to use the actual figures published by the federal government and to no longer use the numbers that have historically been provided to the Company by the Maricopa Community Action Association. (Tr. p. 1279, ln. 25 through p. 1280, ln. 14.)

5. Purchasing and Gas Procurement.

a. Southwest accepts Staff's proposals to conduct a best practices review of the fuel procurement and planning functions by an impartial outside organization and review non-gas commodity hedging; provide a check and balance in the fuel procurement process that would separate contract award authority from invoice approval authority; eliminate the use of cell phones during term fuel bidding and negotiating activities and to ensure all discussions are recorded and bidding and negotiation activities are observed by neutral personnel; perform a review of available portfolio evaluation software; investigate how peer utilities address commodity price hedging, with an emphasis on steel; develop and implement standard practices and procedures, within 60 days from the date of a Commission decision in this proceeding, that define or establish measurement criteria for what constitutes substantial stock or other financial interest in any supplier and applies to individuals within the purchasing and gas procurement departments; and to file a report in Docket Control within 60 days from the date of a Commission decision in this matter providing a scope of work for portfolio evaluation software review and a non-gas commodity price hedging survey, with an emphasis on steel. (Moody Rejoinder Testimony, pp. 2-4 and Tr. pp. 433 and 1107-1109.)

VIII.
MISCELLANEOUS ISSUES

There are several miscellaneous issues [e.g., several of Staff's individual tariff-related issues, Staff's Gas Technology Institute-funding issue, demand-side management proposals, RUCO's Construction Completed Not Classified issue and RUCO's pipe replacement issue] that were addressed in Southwest's Post-Hearing Brief and, with respect to which, neither Staff nor RUCO has presented any new argument. As such, Southwest's commentary would be redundant. Accordingly, Southwest refers the Judge and the Commissioners to Southwest's Post-Hearing Brief for its argument and position on all issues not specifically addressed herein.

IX.
SUMMARY AND CONCLUSION

It is rather apparent that this case is about providing Southwest with a realistic opportunity to realize the Commission-authorized rate of return. The achievement of such a result depends on (1) the recovery of all reasonable, ongoing operating expenses and (2) a rate design [or decoupling mechanism] which best ensures that factors outside the control of Southwest do not jeopardize the opportunity to realize the Commission-authorized margin.

What is most noteworthy is that the interests of both Southwest investors and customers are aligned when it comes to realizing the Commission-authorized rate of return because Southwest's capital structure would likely be strengthened, which should result in higher credit ratings and, as a consequence, lower capital costs. Consequently, both the Company and its customers have been negatively impacted by the Company not earning the authorized rate of return in ten of the past eleven years. Even Staff's witness Mr. Hill, who recommends the lowest rate of return in the case, recognizes that, with a strengthened capital structure, Southwest's customers would experience lower capital costs. (*See* lines 17-22 on page 26 of Hill Direct Testimony, Exhibit No. S-1.)

Based on the record as a whole, and for all the reasons set forth in Southwest's Post-hearing Brief and this Reply Brief, Judge Nodes is respectfully urged to recommend, and the Commissioners are respectfully urged to approve, Southwest's recommended revenue requirements, including the embedded cost of capital recommendations, and a rate design and/or an explicit decoupling mechanism which best ensures a reasonable opportunity to recover the Commission-authorized level of margin.

Respectfully submitted this 14th day of November, 2005.

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APPENDIX 1

American Gas Association

NATURAL GAS RATE ROUND-UP

A Periodic Update on Innovative Rate Designs

November 2005

Decoupling Mechanisms

This issue of the *AGA Rate Roundup* describes a rate design method that helps utilities to promote energy efficiency while preventing the erosion of margins that is the usual outcome of customer conservation and utility energy efficiency.

DESCRIPTIONS AND COMPONENTS

Decoupling Programs

Traditional rate designs allow utilities to collect payments from consumers every month to cover the actual cost of natural gas (a pass-through cost, with no utility mark-up), as well as government taxes and the utility's fixed costs. After delivering a sufficient volume of natural gas to cover all of those items, a utility has the opportunity to earn its regulated profit. However, the traditional rate design ties a utility's profitability to the volume of natural gas that customers use. When the amount of gas consumed declines, as it does during periods of warmer than normal weather, and when natural gas consumers become more energy efficient, even a small reduction in natural gas consumption can significantly cut into a utility's profitability. This presents a strong financial disincentive for natural gas utilities to promote energy efficiency aggressively.

To remedy this situation, several natural gas utilities have worked with their state regulators to reform the way their rates are designed, by separating or "de-coupling" the utility's recovery of its fixed costs from the volume of natural gas delivered to customers. The impetus for this rate re-design has been, primarily, the problem of declining use per customer and the fact that weather has been consistently warmer than normal, on average, for many years. These decoupling mechanisms, or margin tracking mechanisms, use periodic adjustments called "true-ups" to move customers' rates up or down modestly to ensure that utilities recover their authorized fixed costs regardless of fluctuations in energy use.

Conservation Components

Regardless of the volumes of gas delivered by the utility, decoupling rate designs provide a better chance of recovery of the utility's fixed costs than do traditional rate designs. Decoupling rate designs remove the disincentives that utilities face in promoting energy efficiency. Conservation tariffs are the rate design components that give consumers an incentive to conserve natural gas. Not all decoupling programs include a conservation component, and not all conservation tariffs also include a decoupling mechanism.

At least 29 natural gas utilities have tariff provisions that allow recovery of conservation and demand side management program costs, as well as recovery of lost net revenues caused by the reduction in sales. The programs differ in what costs are allowed recovery (e.g., program costs, administrative costs, lost margin costs) and who administers the program (e.g., company, state, or charitable organization). One example is NW Natural, which includes a conservation component in its current decoupling mechanism that is administered by an outside charitable foundation. Another example is Vermont Gas, which does not have a decoupling program, but does have a Demand Side Management and Energy Efficiency program, in which the utility funds a portion of customers' costs of purchasing new, more energy-efficient appliances. Vermont Gas' defers the costs of the program until its next rate case and subsequently amortizes the costs over a three-year period and charges the costs to all ratepayers.

Computational Options

There are several options for calculating the revenue adjustment, or true-up, and while the results are approximately the same, the different options help companies meet unique regulatory preferences and circumstances. The use-per-customer basis makes a rate adjustment that is based on changes in average use per customer and then applies that adjustment factor against unit margins by customer class. The margin-per-customer rate adjustment is based on the change in baseline margin per customer compared to the actual margin per customer. The total margin revenue adjustment is based on comparison of total baseline margin revenues to actual margin revenues.

Variants –Fixed Variable Rate Design

More than one rate design method exists that will break the link between volumes of gas consumed and cost recovery for the utility. Fixed variable rate design places all of the utility's fixed costs, including a regulated profit on the value of the utility's investment in plant and equipment used to provide service to the customer, into a fixed monthly charge called a service charge or a demand charge. This charge is similar to the monthly fee charged by cable TV companies and is unrelated to the amount of gas (or number of TV programs) used by the customer. Several utilities currently utilize a fixed charge type of rate design for recovery of their costs. AGA will further discuss this rate design mechanism in the next *Rate Round-Up.*

Similar Mechanisms – Return Stabilization

Return stabilization, also known as rate stabilization and revenue stabilization, is another rate design mechanism that decouples a utility's profits from its gas throughput. The mechanism works by adjusting the utility's monthly revenues up or down to meet pre-established revenue and return targets. The amount calculated is added to or subtracted from the commodity charge of the utility in the next month and the utility files a revised rate schedule with the regulator. Several AGA members have received approval for these mechanisms. An upcoming *Rate Round-Up* will discuss these related mechanisms in more detail.

CURRENT DECOUPLING PROGRAMS

NW Natural - Oregon

The Public Utility Commission of Oregon approved a decoupling tariff for NW Natural in September of 2002. The PUC said the tariff was designed "to break the link between an energy utility's sales and its profitability, so that the utility can assist its customers with energy efficiency without conflict." The tariff was a partial decoupling mechanism that allowed NW Natural to defer and then amortize 90 percent of the margin differentials for the residential and commercial customer groups. The mechanism contained two components: 1) a "price elasticity" factor that adjusted for increases or decreases in consumption attributable to annual changes in commodity costs or periodic changes in the company's general rates; and 2) a decoupling adjustment calculated on a monthly basis that accounted for deviations in expected volumes. Weather related risks were not covered by the mechanism. The additional company revenues or credits to customers produced by the mechanism were booked to a deferral account that was reconciled as part of the company's annual purchased gas adjustment.

The NW Natural decoupling tariff was put in place for three years on a pilot basis and had a sunset date of September 30, 2005, unless extended by the PUC. In March of 2005, NW Natural asked the PUC to investigate whether the decoupling tariff should continue. As part of the petition, NW Natural submitted the results of an independent study that had been required under the original order.

In August 2005, the Oregon PUC extended NW Natural's partial decoupling mechanism for an additional four years. NW Natural revised the decoupling schedule to provide for 100 percent deferral and amortization of the margin differentials. This change eliminated the non-weather related margin variability related to distribution fixed costs. In addition to the decoupling provisions, NW Natural currently has in effect a weather-adjusted rate mechanism (WARM) that was adopted in an earlier rate case and that lasts until September 30, 2008. The WARM covers all residential and small commercial customers, unless the customers opt out. The 2005 decoupling case dictates that public purpose funding and low-income assistance programs will remain in effect throughout the life of the decoupling program. In addition, industrial customers will not be charged or be eligible for any of the assistance programs.

NW Natural has a conservation component to its decoupling program that provides an indirect efficiency incentive to its customers. The company collects from all of its residential and commercial customers a "public purpose" surcharge of 1.5 percent of their total monthly bills. The funds are then passed on to an independent, non-profit organization, the Energy Trust of Oregon. The Energy Trust, which also receives funding from public purposes surcharges from all of Oregon's electric utilities, then provides grants to promote energy-efficiency and renewable resources among homes and businesses.

The Energy Trust of Oregon disburses approximately $6 million each year to encourage more efficient use of natural gas. Incentives include: $450 - $825 per unit to builders of new home construction if natural gas service is installed; rebates for high-efficiency gas furnaces, water heaters (including tankless units) and other appliances in existing homes; rebates on insulation, new windows and other efforts to reduce home energy use; and rebates on the installation of tankless water heaters, efficient boilers, etc. in commercial buildings.

Baltimore Gas and Electric and Washington Gas Light - Maryland

BG&E's decoupling program began in 1998, while Washington Gas Light's mechanism began in October of 2005. The programs, which are similar in design, are "full decoupling" programs, in that they are designed to recover multiple sources of margin loss, including weather and price elasticity, as well as losses caused by customers' conservation and energy efficiency. The Maryland decoupling mechanism utilizes a balancing account that returns to customers excess margin when revenues exceed authorized levels.

The companies make adjustments to the delivery price of gas under the applicable schedules to reflect test year base rate revenues established in the latest base rate proceeding, after adjustment to recognize the subsequent change in the number of customers from the test year level. Test year average use per customer is multiplied by the net number of customers added since the like-month during the test year. The product is added to test year revenue to restate test year revenues for the month to include the revised values. Actual revenues collected for the month are compared to the restated test year revenues and any difference is divided by estimated sales for the second succeeding month to obtain the adjustment to the applicable delivery price. Any difference between actual and estimated sales is reconciled in the determination of the adjustment for a future month. Details of the calculation of the billing adjustment are filed monthly with the Public Service Commission.

Southwest Gas Co. - California

California has had some variation of a decoupling program in place for most of its utilities for nearly 30 years. The impetus for the program was the enactment of lifeline rates legislation, gas supply constraints, and the adoption of demand side management programs by the state. In its most recent general rate case order, effective April 15, 2004, Southwest was granted authority to implement a decoupling mechanism. The decoupling mechanism utilizes a balancing account to protect customers if base revenues exceed authorized levels, and to protect stockholders if base revenues are less than authorized levels. The program is firmly established and utilizes a long-standing regulatory construct that does not recognize an explicit reduction to ROE.

Future test year system annual revenue requirement (margin) is established in a rate case as a fixed dollar amount on a monthly and annual basis. The difference between billed margins and authorized margins, plus carrying costs, is recorded monthly in a deferred account. The account balance is amortized annually through a uniform cents-per-therm rate applicable to all schedules, except special contracts. The test year margin amount increases each January 1 (between rate cases) according to an established formula.

Piedmont Natural Gas – North Carolina

The newest decoupling tariff, approved by the North Carolina Utilities Commission in November 2005, gave Piedmont Natural Gas permission to implement a Customer Utilization Tracker (CUT). The mechanism is approved as an experimental, provisional tariff for a period of no more than three years and will automatically terminate on November 1, 2008, unless renewed in a general rate case. During the life of the CUT, Piedmont has agreed to contribute $500,000 per year toward conservation programs. Adoption of the CUT also results in the elimination of the company's existing weather normalization adjustment mechanism.

PROPOSED DECOUPLING MECHANISMS

- **Cascade Natural Gas** - The Washington Utilities and Transportation Commission unveiled in May 2005 a proposal to decouple utilities' gas volume sales from their recovery of fixed costs. As part of the proceeding, the commission is considering a decoupling proposal by Cascade Natural Gas. The filing was by petition and outside of a rate case.
- **Cascade Natural Gas** filed a petition with the Oregon Public Service Commission in October 2005 to request consideration of a decoupling mechanism. The filing was not part of a general rate case.
- In 2004, **Citizens Gas & Coke Utility** in Indianapolis, Ind., filed a general rate case with the Indiana Utility Regulatory Commission for the first time in 14 years. Citizens Gas proposed a Volume Variance and Conservation Adjustment (VVCA) mechanism that would adjust rates up or down on a monthly basis to allow the utility to recover its allowed revenue requirement, regardless of fluctuations in customer gas use caused primarily by the energy efficiency efforts of its customers and variations from normal weather. The proposed VVCA is an integral part of Citizens Gas' proposed comprehensive Energy Efficiency Program.
- **Montana-Dakota Utilities (MDU)** in Montana has proposed a mechanism that is identical to the NW Natural decoupling mechanism and has also proposed a weather normalization clause to recover weather-related margin losses. MDU will propose a conservation component in 2006.
- **Southwest Gas Corp.** made a filing with the Arizona Corporation Commission on Dec. 9, 2004, that includes a request to restructure residential rates in order to separate the recovery of fixed operating costs from the volume of gas the utility sells. Southwest noted that while its residential customer growth rate exceeds 5 percent per year, it has experienced a decline in residential average use of approximately 2 percent per year, and has earned its authorized ROR in only one of the last 10 years.

  The program would establish test year residential margin per customer in a general rate case. The monthly authorized margin per residential customer times the actual number of residential customers billed for the month equals the total authorized margin each month. The difference between the billed margin and the authorized margin, plus the carrying costs for the month, would be recorded in a deferred account and the account balance would be amortized annually through a uniform cents-per-therm rate applicable to residential customers.
- **Vectren Energy Delivery** has petitioned the Indiana Utility Regulatory Commission for permission to implement a conservation program, "in order to preserve its ability to provide reliable, low cost service, as well as create the financial stability required to position it to promote gas conservation on behalf of its customers." As proposed, the Conservation Adjustment will consist of two interrelated components: the conservation funding rider, and the decoupling mechanism. The company filed a petition rather than a new rate case for the conservation program.

PREVIOUSLY PROPOSED MECHANISMS

- **NW Natural's** 2004 rate case settlement in Washington authorized further study. See Cascade Natural gas proposal above.
- **Vectren Energy Delivery** eliminated a proposal from its 2004 Ohio rate case settlement.
- **Xcel Energy** eliminated a decoupling proposal from its Minnesota rate case settlement.

HOW WELL HAVE THEY WORKED?

- **Decoupling programs, which have been accepted for many years in California and Maryland, have protected utilities from margin loss caused by declining use per customer.** These mechanisms compare recent base rate revenue targets against actual revenue, and usually adjust for growth. The use and acceptance of these programs appears to be growing.
- **An independent evaluation of NW Natural's decoupling and conservation tariffs, compiled in March 2005, found the programs to be worthwhile and in the public interest**. Among the conclusions of the evaluators were that: the mechanism is effective in reducing the variability of utility revenues; the mechanism removes disincentives to promote energy efficiency; public purpose funding established in conjunction with the conservation component is beneficial to consumers; negative feedback was limited to complaints questioning the appropriateness and/or the legality of public purpose funding; and the mechanism does not reduce the incentive for good customer service.
- **Additional advantages of the program include: reduction of rate cases, reliance on basic rate formulas that have been utilized for decades, and the ease of audit.**
- **A disadvantage of decoupling is that regulators and advocates may seek a reduced return or other concessions as a trade-off or as a bargaining chip.**

RESOURCES:
COMPANIES, RATE ORDERS, WEBSITES, CONTACTS, ETC.

- **Baltimore Gas & Electric – Maryland** – Approved – Maryland Case No. 8780, Feb. 2005, *http://webapp.psc.state.md.us/Intranet/CaseNum/NewIndex3_VOpenFile.cfm?ServerFilePath=C%3A%5CCasenum%5C8750%2D8799%5C8780%5C049%2Edoc*, *Contact Laurie Duhan @ 410-265-4031*
- **Cascade Natural Gas – Oregon** – Currently Proposed – , October 2005; http://edocs.puc.state.or.us/efdocs/UAA/ug167uaa92146.pdf, *Contact Jon Stoltz @206-624-3900*
- **Cascade Natural Gas – Washington** – Currently Proposed – , May 2005; *http://www.wutc.wa.gov/webimage.nsf/34bbcde06f5ab31a8825704d006e98fe/0e699dd89acd5b1888256fdd00681656!OpenDocument*, *Contact Jon Stoltz @206-624-3900*
- **Citizens Gas & Coke Utility – Indiana** – Currently Proposed – December 9, 2004, *http://www.citizensgas.com/pdf/NewsRelease/baserateincrease04.pdf ; Contact LaTona Prentice @ 317-927-4529*
- **Montana-Dakota Utilities – Montana** – Currently Proposed –Montana Docket No. D2005.9.148; *Contact Don Ball @ 701-222-7630*
- **NW Natural – Oregon** – Approved - Order No. 05-1041, September 26, 2005; *http://apps.puc.state.or.us/orders/2005ords/05-1041.pdf, Contact C. Alex Miller @ 503-721-2487*
- **NW Natural – Washington** – Rate case settlement authorized further study - 2004; *Contact C. Alex Miller @ 503-721-2487*
- **Piedmont Natural Gas – North Carolina** – Approved – Dockets G-9, Sub 499, G-21 Sub 461, G-44 Sub 15, November 3, 2005; http://ncuc.commerce.state.nc.us/docksrch.html, *Contact: Bill Morris @ 704-364-3120*

- **Southwest Gas** – **Arizona** – Currently Proposed – December 9, 2004; http://www.southwestgas.com/news/newsreleases.php?val=AZ&the_year=2004&the_month=12&the_day=09&doc_number=1&p12m=Y; *Contact Roger Montgomery @ 702-876-7321*
- **Southwest Gas** – **California** – Approved – California Application No. 02-02-012, Decision No. 04-03-034; *Contact Roger Montgomery @ 702-876-7321*
- **Southwest Gas** – **Nevada** – Not approved – Nevada, July 2004; *Contact Roger Montgomery @ 702-876-7321*
- **Vectren Energy Delivery** – **Indiana** – Currently Proposed – Indiana URC Cause No. 42943, October 25, 2005; *Contact Scott Albertson @ 812-491-4682*
- **Vectren Energy Delivery** – **Ohio** – Eliminated from rate case settlement – Ohio PUC, Feb 2004; *Contact Scott Albertson @ 812-491-4682*
- **Washington Gas Light** –**Maryland** – Approved – Maryland Case No. 8990, October 1, 2005, http://webapp.psc.state.md.us/Intranet/maillog/orders.cfm *Contact Paul Buckley @ 703-750-5260*
- **Xcel Energy** – **Minnesota** – Eliminated from rate case settlement; *Contact Amy Liberkowski @* amy.a.Liberkowski@xcelenergy.com

ADDITIONAL INFORMATION

If you would like more information about a particular program or would like to speak to another AGA member regarding the details of the program, please contact: *Cynthia Marple*, AGA director of rates and regulatory affairs, cmarple@aga.org or 202-824-7228.

Want to learn more? AGA hosted an audio conference on "Decoupling, Conservation, and Margin Tracking Mechanisms" on October 27, 2005. Copies of the seminar presentations are at: ***http://www.aga.org/Template.cfm?Section=Audioconference_Series&Template=/MembersOnly.cfm&NavMenuID=828&ContentID=18221&DirectListComboInd=D***

Coming Up:

The next edition of the AGA Rate Roundup will cover fixed variable rate design programs. If your company offers such a mechanism, please contact Cynthia Marple.

Previous Editions:

The June 2005 *Rate Round-Up* focused on Fixed Bills and Fixed Gas Price Options. Find this Round-Up at:
http://www.aga.org/Template.cfm?Section=Rate_Roundup&Template=/MembersOnly.cfm&ContentID=16904.

The March 2005 *Rate Round-Up* covered pipeline integrity management cost recovery techniques. Read this Round-Up at:
http://www.aga.org/Template.cfm?Section=Rate_Roundup&Template=/MembersOnly.cfm&ContentID=15950.

The November 2004 *Rate Round-Up* on Bad Debt Cost rate designs can be found at:
http://www.aga.org/Template.cfm?Section=Rate_Roundup&Template=/MembersOnly.cfm&ContentID=14907

APPENDIX 2

SOUTHWEST GAS CORPORATION
ILLUSTRATIVE APPLICATION OF CONSERVATION MARGIN TRACKER

		Year One		Year Two				
Line No.	Description	Customer One Who Does Not Implement Conservation	Customer Two Who Does Implement Conservation	Customer One Who Does Not Implement Conservation	Customer Two Who Does Implement Conservation	Customer One Total	Customer Two Total	Line No.
	(a)	(b)	(c)	(d)	(e)	(f)	(g)	
1	Average Annual Residential Use per Customer Used For Rate Design	347	347	347	347	694	694	1
2	Change in Average Use	0	(20)	0	(20)	0	(40)	2
3	Actual Use Per Customer	347	327	347	327	694	654	3
	Southwest 2nd Block Commodity Rate per Therm							
4	Margin Rate	$ 0.25000	$ 0.25000	$ 0.25000	$ 0.25000			4
5	Gas Cost	$ 0.65000	$ 0.65000	$ 0.65000	$ 0.65000			5
6	CMT Surcharge	n/a	n/a	$ 0.00742 [1]	$ 0.00742 [1]			6
	Savings Related to Conservation							
7	Margin (Line 2 X Line 4)	$ -	$ (5.00)	$ -	$ (5.00)	$ -	$ (10.00)	7
8	Gas Cost (Line 2 X Line 5)	0.00	(13.00)	0.00	(13.00)	0.00	(26.00)	8
9	CMT Surcharge (Line 3 X Line 6)	0.00	0.00	2.57	2.43	2.57	2.43	9
10	Total Savings (Line 7 + Line 8 + Line 9)	$ -	$ (18.00)	$ 2.57	$ (15.57)	$ 2.57	$ (33.57)	10

[1] CMT surcharge equal to $(5.00) divided by 674 therms.

APPENDIX 3

SOUTHWEST GAS CORPORATION
P.O. Box 98510
Las Vegas, Nevada 89193-8510
Nevada Gas Tariff No. 6

Eighteenth Revised P.U.C.N. Sheet No. 12
Canceling Seventeenth Revised P.U.C.N. Sheet No. 12

STATEMENT OF RATES
EFFECTIVE RATES APPLICABLE TO SOUTHERN NEVADA DIVISION SCHEDULES 1/2/3/

Schedule Number & Type of Charge	Per Meter Per Month	Margin	Base Tariff Energy Rate: Reservation Charge Component	Base Tariff Energy Rate: Commodity Cost Component	Deferred Energy Account Adjustment	Currently Effective Tariff Rate
SG-1 – Single-Family Residential Gas Service						
Summer (May – October)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 15 Therms		$ .34486	$ .07525	$ .68825	$ .10128	$ 1.20964
Over 15 Therms		.15387	.07525	.68825	.10128	1.01865
Winter (November – April)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 45 Therms		$ .34486	$ .07525	$ .68825	$ .10128	$ 1.20964
Over 45 Therms		.15387	.07525	.68825	.10128	1.01865
SG-2 – Multi-Family Apartment Residential Gas Service						
Summer (May – October)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 10 Therms		$ .34486	$ .07525	$ .68825	$ .10128	$ 1.20964
Over 10 Therms		.15387	.07525	.68825	.10128	1.01865
Winter (November – April)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 20 Therms		$ .34486	$ .07525	$ .68825	$ .10128	$ 1.20964
Over 20 Therms		.15387	.07525	.68825	.10128	1.01865
SG-5(S) – Small General Gas Service						
Basic Service Charge	$ 21.50					$ 21.50
Commodity Charge per Therm:						
All Usage		$ .25140	$ .07525	$ .68825	$ .10128	$ 1.11618
SG-5(M) – Medium General Gas Service						
Basic Service Charge	$ 30.00					$ 30.00
Commodity Charge per Therm:						
All Usage		$ .20085	$ .07525	$ .68825	$ .10128	$ 1.06563

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November 1, 2005

Advice Letter No.:
416

Issued by
John P. Hester
Vice President

SOUTHWEST GAS CORPORATION
P.O. Box 98510
Las Vegas, Nevada 89193-8510
Nevada Gas Tariff No. 6

Seventeenth Revised P.U.C.N. Sheet No. 16
Canceling Sixteenth Revised P.U.C.N. Sheet No. 16

STATEMENT OF RATES
EFFECTIVE RATES APPLICABLE TO NORTHERN NEVADA DIVISION SCHEDULES 1/2/3/

Schedule Number & Type of Charge	Per Meter Per Month	Margin	Base Tariff Energy Rate: Reservation Charge Component	Base Tariff Energy Rate: Commodity Cost Component	Deferred Energy Account Adjustment	Currently Effective Tariff Rate
NG-10 – Single-Family Residential Gas Service						
Summer (May – October)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 20 Therms		$ .48722	$ .26154	$ .70816	$ .07008	$ 1.52700
Over 20 Therms		.15374	.26154	.70816	.07008	1.19352
Winter (November – April)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 65 Therms		$ .48722	$ .26154	$ .70816	$ .07008	$ 1.52700
Over 65 Therms		.15374	.26154	.70816	.07008	1.19352
NG-11 – Multi-Family Apartment Residential Gas Service						
Summer (May – October)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 10 Therms		$ .48722	$ .26154	$ .70816	$ .07008	$ 1.52700
Over 10 Therms		.15374	.26154	.70816	.07008	1.19352
Winter (November – April)						
Basic Service Charge	$ 8.50					$ 8.50
Commodity Charge per Therm:						
First 30 Therms		$ .48722	$ .26154	$ .70816	$ .07008	$ 1.52700
Over 30 Therms		.15374	.26154	.70816	.07008	1.19352
NG-18 – Air-Conditioning Gas Service						
Basic Service Charge	$ 24.00					$ 24.00
Commodity Charge per Therm: All Usage		$ .06866	$ .26154	$ .70816	$ .07008	$ 1.10844

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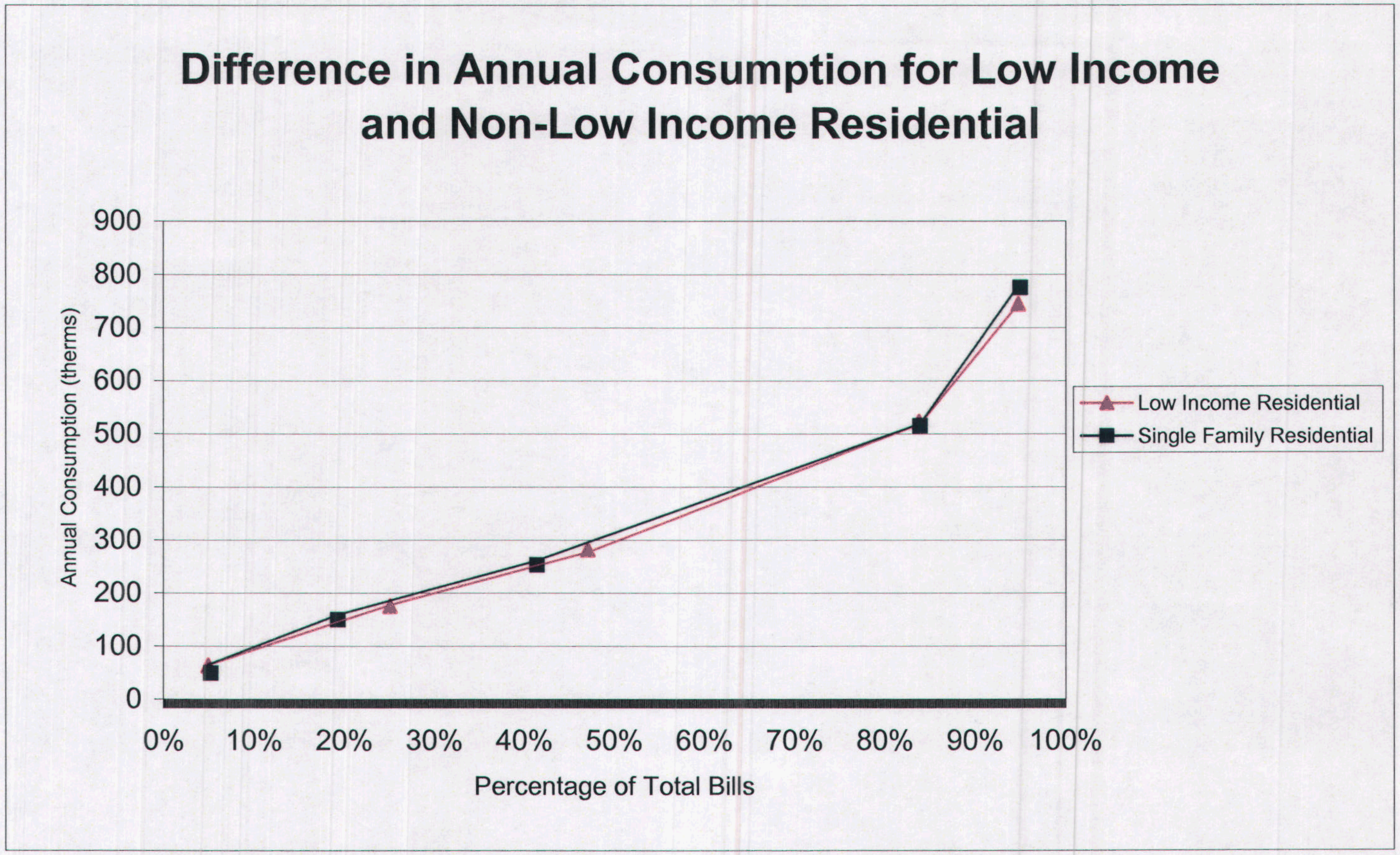
Issued by
John P. Hester
Vice President

APPENDIX 4



Difference in Annual Consumption for Low Income and Non-Low Income Residential
Annual Consumption (therms)
900
800
700
600
500
400
300
200
100
0
0%
10%
20%
30%
40%
50%
60%
70%
80%
90%
100%
Percentage of Total Bills
Low Income Residential
Single Family Residential

APPENDIX 5

BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION FOR A GENERAL CHANGE OR MODIFICATION IN CENTERPOINT ENERGY, ARKLA, A DIVISION OF CENTERPOINT ENERGY RESOURCES CORP.'S, RATES, CHARGES, AND TARIFFS	))))))	DOCKET NO. 04-121-U

PREPARED TESTIMONY

OF

JOHNNY BROWN
SENIOR FINANCIAL ANALYST
FINANCIAL ANALYSIS SECTION

ON BEHALF OF THE GENERAL STAFF
OF THE ARKANSAS PUBLIC SERVICE COMMISSION

MAY 24, 2005

A. The purpose of my testimony is to make recommendations on the overall rate of return required for CenterPoint Energy Arkla (Arkla or the Company), a division of CenterPoint Energy Resources Corp. (CERC).[1] I will also address the Direct Testimony of Company witness Samuel C. Hadaway and portions of the Direct Testimony of Company witness Charles J. Harder, filed on December 3, 2004.

Q. Please summarize your recommendations.

A. The Company is requesting a cost of equity of 11.25% and an overall cost of capital of 9.01%, which results in a pre-tax return of 12.79%. My analysis produced a required cost of equity for Arkla in the range of 9.2% to 10.1%. For reasons discussed in the Prepared Testimony of Staff witness Robert D. Booth, Staff is recommending that Arkla have the opportunity to earn the lower end of this range, or 9.2%, on its equity investment. Based on Staff's point recommendation for the cost of equity the overall rate of return for Arkla is 5.07%, which is a pre-tax return of 6.96%.

ARKLA DESCRIPTION

Q. Please describe the relationship of Arkla, CERC, and CenterPoint Energy, Incorporated (CenterPoint Energy).

A. Arkla is a division of CERC, which is a subsidiary of CenterPoint Energy. CenterPoint Energy, a publicly-traded company, is a diversified energy services and energy delivery

[1] In a footnote to page 5 of his Direct Testimony, Charles J. Harder states that effective December 1, 2004, CenterPoint Energy renamed its "Arkla/Entex" business unit as "Southern Gas Operations," and it renamed its "Arkansas Division" as "Arkansas Gas"

A. No. Dr. Hadaway relied upon a sample approach for determining the relative proportions of external capitalization. Arkla's actual four-quarter average total debt-to-equity ratio through December 31, 2004 was 62% total debt to 38% total equity.[7]

Q. What were the relative proportions of total debt and total equity for your sample?

A. The average total debt to total equity ratio[8] was 54:46, as shown in Exhibit JB-2. I calculated these ratios from each company's financial statements for the four quarters ending December 31, 2004.[9] In the absence of Company-specific capital structure and cost rates determined in the capital markets, a market-based sample approach forms the basis for my recommendations. To maintain consistency it is necessary for ratemaking purposes to utilize the sample average relationship of external capital components to correspond with the sample average cost rates. Thus, consistent with the basis for my determination of the cost of equity for Arkla, I included more equity in the capital structure than the Company's books actually support.

Q. You mentioned earlier Dr. Hadaway utilized a similar approach to compute the relative proportions of debt and equity in the capital structure. What are the differences between your approach and the Company's?

---

[7] Calculated from balance sheet information provided in response to Staff Interrogatory AUD-357

[8] Total Debt / Total Capital: The sum of notes payable and other short-term obligations (including current maturities of long-term debt and capital lease obligations), plus long-term debt (including capital lease obligations) divided by the sum of short-term debt, long-term debt, preferred stock (including subsidiary preferred stock), minority interest, and common equity. S&P Ratings and Ratios, 2002, p. 55.

[9] The information was drawn from each company's 2004 annual report and the 10Q reports for the noted quarter ends. Piedmont Natural Gas Company's fiscal year end is October 31. Therefore, for Piedmont Natural Gas, the capital components were measured for the four quarters ending January 31, 2005.

associated with a point-in-time measurement of capital components were first identified by the Company in Docket No. 93-081-U. Computing average capital components normalizes the relative relationship of external capital components throughout the year.

Q. How did you determine the appropriate proportions of short-term and long-term debt within the total debt component?

A. I relied upon the four quarter average proportion of short-term and long-term debt through December, 2004, as presented in Exhibit JB-2. To compute total debt to total capital, I basically followed the S&P calculation as described earlier in my testimony. For the purpose of this proceeding, I included current maturities of long-term debt in the long-term debt balance. In addition to current maturities bearing the higher cost of long-term debt, it is reasonable to assume that this component will be replaced with long-term financing in the relatively near future.

Q. How did you determine the appropriate proportions of preferred stock and common equity within the total equity component?

A. Again, I utilized the same four quarter average for the eight-company sample.

Q. What proportions are you recommending for Arkla?

A. I recommend applying the four quarter average proportions through December 31, 2004 from the sample of eight LDCs. As presented in Exhibit JB-2, I am recommending a capital structure with a debt-to-equity ratio of 54:46 consisting of 46.21% long-term debt, 8.12% short-term debt, 0.03% preferred stock, and 45.64% common equity. These relative relationships of external capital components are representative of a stand-alone, market-traded LDC and are reasonable for the purposes of establishing Arkla's rates.

Q. Does the capital structure resulting from your risk-comparable sample approach produce a reasonable result?

A. Yes. I evaluated the average of the sample relative to S&P's published financial benchmark for total debt to total capital. The sample average of 54% total debt falls within the acceptable range for this benchmark. Finding the results to be reasonable and fair to both the ratepayer and the shareholder, I applied them to Arkla. These recommendations, taken as a whole, are a consistent evaluation and application of the sample averages.

CAPITAL COMPONENT BALANCES

Q. How did you determine Arkla's allocated amounts of external capital funding?

A. Consistent with the measurement of rate base, I included the total external capital amount of $469,338,109 at February 28, 2005, which consists of long-term debt adjusted for the amortization of debt discounts, expenses and losses, in the amount of $181,121,893, short-term debt adjusted to remove the effects of factoring in the amount of $107,252,309 provided by Staff witness L.A. Richmond, and common equity in the amount of $180,963,907 provided in response to Staff Interrogatory AUD-357. I then distributed this total external capital amount among the various external components using the sample proportions described above, as shown in Staff Exhibit JB-3, and presented below:

Long-Term Debt	$216,881,140	46.21%
Short-Term Debt	$ 38,110,254	8.12%
Preferred Stock	$ 140,801	0.03%
Common Equity	$214,205,913	45.64%
Total	$469,338,109	100.0%

SUMMARY OF RECOMMENDATIONS

Q. Please summarize your recommendations to the Commission.

A. I evaluated the Company's requested rate of return and concluded that its proposed departure from the Commission's traditional approach for determining capital structure is unsubstantiated and improper, and that its requested return on equity exceeds a reasonable range of required equity returns based on the current market environment. I therefore recommend that the Commission deny the Company's request for an overall return of 9.01% including a return on equity of 11.25%.

My recommended capital components and cost rates were developed recognizing the fungibility of capital sources and using a sample of market-traded gas LDCs which provides a reasonable standard upon which to base Arkla's overall cost of capital. This results in a range of reasonableness of the required return on equity of 9.2% to 10.1%. The recommendation of Staff witness Robert D. Booth to utilize the lower end of my recommended range produces an overall cost of capital of 5.07% using the various components presented in Exhibit JB-14.

My recommendations consider the current economic climate, consistently apply the sample average methodology, satisfy bond rating agency benchmarks, and compensate Arkla's investors for the risks associated with an investment in a regulated, stand-alone natural gas LDC, thus meeting the standards of what constitutes a reasonable rate of return. I therefore recommend that the Commission approve my recommended 5.07% overall cost of capital.

Q. Does this conclude your testimony at this time?

A. Yes, it does.

BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION FOR A GENERAL CHANGE OR MODIFICATION IN CENTERPOINT ENERGY, ARKLA, A DIVISION OF CENTERPOINT ENERGY RESOURCES CORP.'S, RATES, CHARGES, AND TARIFFS))))))

DOCKET NO. 04-121-U

PREPARED EXHIBITS

OF

JOHNNY BROWN
SENIOR FINANCIAL ANALYST
FINANCIAL ANALYSIS SECTION

ON BEHALF OF THE GENERAL STAFF
OF THE ARKANSAS PUBLIC SERVICE COMMISSION

MAY 24, 2005

CENTERPOINT ENERGY ARKLA
A DIVISION OF CENTERPOINT ENERGY RESOURCES CORP.
PREPARED EXHIBITS OF JOHNNY BROWN

EXHIBIT JB-1

Risk-Comparable Sample

Company	**LDC Revs**	**S&P Rating**	**Total Revenues (millions)**	**Total Capital (millions)**	**Number of Customers**
AGL RESOURCES INC	95%	A-	$984	$1,901	2,000,000
CASCADE NATURAL GAS CORP.	100%	BBB+	$303	$256	214,000
LACLEDE GROUP	74%	A	$1,050	$605	630,000
NICOR, INC	86%	AA	$2,663	$1,252	2,000,000
NORTHWEST NATURAL GAS	98%	A+	$611	$1,007	567,479
PEOPLES ENERGY CORPORATION	71%	A-	$2,138	$1,592	1,000,000
PIEDMONT NATURAL GAS	100%	A	$1,221	$1,090	940,000
SOUTHWEST GAS CORPORATION	84%	BBB-	$1,231	$1,852	1,600,000

Sources: Value Line Investment Survey, December 17, 2004, www.standardandpoors.com/ratingsdirect

Risk-Comparable Sample
External Capital Component
Proportions and Amounts

Company	4 Quarter Average Amounts (millions)			
	L-T Debt	**S-T Debt**	**Preferred**	**Common**
AGL RESOURCES INC	1,218.7	161.4	0.0	1,102.7
CASCADE NATURAL GAS CORP.	151.4	19.9	0.0	122.2
LACLEDE GROUP	299.4	110.9	1.1	354.6
NICOR, INC	542.0	326.7	1.7	746.1
NORTHWEST NATURAL GAS	499.9	53.3	0.0	553.1
PEOPLES ENERGY CORPORATION	871.8	81.9	0.0	887.8
PIEDMONT NATURAL GAS	660.5	81.5	0.0	887.3
SOUTHWEST GAS CORPORATION	1,261.8	54.0	0.0	676.1
AVERAGE	688.2	111.2	0.3	666.2

Company	4 Quarter Average Proportions			
	L-T Debt	**S-T Debt**	**Preferred**	**Common**
AGL RESOURCES INC	49.1%	6.5%	0.0%	44.4%
CASCADE NATURAL GAS CORP.	51.6%	6.8%	0.0%	41.6%
LACLEDE GROUP	39.1%	14.5%	0.1%	46.3%
NICOR, INC	33.5%	20.2%	0.1%	46.2%
NORTHWEST NATURAL GAS	45.2%	4.8%	0.0%	50.0%
PEOPLES ENERGY CORPORATION	47.3%	4.4%	0.0%	48.2%
PIEDMONT NATURAL GAS	40.5%	5.0%	0.0%	54.5%
SOUTHWEST GAS CORPORATION	63.3%	2.7%	0.0%	33.9%
AVERAGE	46.21%	8.12%	0.03%	45.64%
Total Debt / Total Equity		54%		46%

Sources: 2004 Annual Reports and 10-Q's

CenterPoint Energy Arkla
External Capital Component
Proportions and Amounts

	L-T Debt	S-T Debt	Preferred	Common	Total
February 2005 Company Balances	$181,121,893	$107,252,309	$0	$180,963,907	$469,338,109
Sample 4 Quarter Average Proportions	46.21%	8.12%	0.03%	45.64%	100.00%
Arkla External Capital Components Based on Sample Proportions	$216,881,140	$38,110,254	$140,801	$214,205,913	$469,338,109

Sources: Exhibit JB-2, Response to Staff Interrogatory AUD-357, Staff witness L.A. Richmond

BEFORE THE
ARKANSAS PUBLIC SERVICE COMMISSION

IN THE MATTER OF THE APPLICATION FOR A GENERAL CHANGE OR MODIFICATION IN CENTERPOINT ENERGY, ARKLA, A DIVISION OF CENTERPOINT ENERGY RESOURCES CORP.'S, RATES, CHARGES, AND TARIFFS	)))))	DOCKET NO. 04-121-U

SURREBUTTAL TESTIMONY

OF

JOHNNY BROWN
SENIOR FINANCIAL ANALYST
FINANCIAL ANALYSIS SECTION

ON BEHALF OF THE GENERAL STAFF
OF THE ARKANSAS PUBLIC SERVICE COMMISSION

JULY 15, 2005

INTRODUCTION

Q. Please state your name.

A. My name is Johnny Brown.

Q. Are you the same Johnny Brown who previously filed testimony in this Docket on May 24, 2005?

A. Yes, I am.

PURPOSE OF TESTIMONY

Q. What is the purpose of your Surrebuttal Testimony?

A. The purpose of my Surrebuttal Testimony is to address the June 21, 2005 Rebuttal Testimony of Centerpoint Energy Arkla (Arkla or Company) witness Hadaway which addresses cost of capital and Company witnesses Harder, Adams, and Henry as they relate to cost of capital issues including Staff's application of the Modified Balance Sheet Approach (MBSA). I will also provide an updated cost of capital recommendation based on changes to Staff's recommended current, accrued, and other liabilities (CAOL) and accumulated deferred income taxes (ADIT) capital components as provided by Staff witness L.A. Richmond.

OVERVIEW

Q. How do your recommendations compare to the other parties'?

A. My recommendations are very similar to the prepared recommendations of the intervener witnesses Marcus, Staley, and John. Mr. Marcus and Mr. Staley both recommend returns on equity that are within my recommended range. Additionally, Mr. Marcus' and Mr. John's recommended downward risk adjustment to the cost of equity to reflect the lower risk of the Company if the requested riders are granted is consistent with my recommendations.

Q. What are the primary areas of disagreement between you and the Company?

A. The primary areas of disagreement continue to be the cost of equity (COE) and the inclusion of short-term debt in the capital structure. Company cost of capital witness Samuel C. Hadaway updated his cost of equity analysis and lowered his recommended rate of return on equity from 11.25% to 10.75%. Dr. Hadaway continues to recommend a capital structure that only includes long-term debt, and preferred and common equity. The Company's requested overall return is now 8.76%, according to Charles J. Harder's Exhibit CJH-9.

Q. Please summarize your Surrebuttal recommendations.

A. Having reviewed and considered the Company's rebuttal testimony, I am not persuaded to change any of my recommended capital structure components, proportions, or cost rates and continue to support a reasonable COE range of 9.2% to 10.1%. For reasons discussed in the Prepared and Surrebuttal Testimony of Staff witness Robert D. Booth, Staff continues to recommend Arkla be allowed the opportunity to earn 9.2% on equity. Also, inherent in Staff's cost of equity recommendation is the capital structure of the risk-comparable sample, which consists of an average of 54% debt and 46% equity – the same ratio as recommended in my Prepared Testimony. I continue to support the use of my sample as an accurate assessment of the risks facing Arkla; and I continue to support a commensurate reduction to my cost of equity range to account for the Company's significantly lower risk, if the requested riders are allowed. The only changes in my recommendations are to CAOL and ADIT balances as per Staff witness Richmond. These updates result in an overall return of 5.24%, as shown in Surrebuttal Exhibit JB-14.

SURREBUTTAL OF CHARLES J. HARDER

Q. Do you agree with Mr. Harder's assertion on page 12 of his Rebuttal Testimony that the "[a]pplication of the MBSA results in a materially deficient return to debt holders and stockholders – when benchmarked against other jurisdictions and natural gas public utilities...?"

A. No. As discussed thoroughly in my Prepared Testimony and later in this testimony, my capital structure and capital cost rates were developed from an analysis of a group of risk-comparable companies, thus, providing an appropriate benchmark for a reasonable cost of capital. Additionally, I checked the reasonableness of my cost of equity recommendations with a risk premium analysis and a cost of equity analysis of a larger industry sample. Further, I checked the overall reasonableness of Staff's recommendations, including the MBSA approach, by calculating several key financial ratios resulting from my overall cost of capital recommendation. These financial ratios are monitored by credit rating agencies and the investment community, and can be used as benchmarks for comparing my cost of capital recommendation to the cost of capital of similar companies. Simply stated, the existence of alternative approaches does not render this Commission's long-standing approach deficient, as substantiated by my assessment of adequacy.

Q. What did your check of the overall reasonableness of your Surrebuttal cost of capital position indicate?

do view electricity as a necessity, Arkansas customers do not view it as any more or less of a necessity than the rest of the nation.

Q. Do you agree with Mr. Henry's implication that "...many of the proxy companies already have in place special programs and enlightened rate design...," suggesting Arkla is somehow disadvantaged in terms of risk?

A. No. I would point back to my discussion of Dr. Hadaway's mention of the sample companies' rate designs. There I pointed out that Arkla has nearly all of the rate mechanisms that Dr. Hadaway, and now Mr. Henry, claims set the Company apart from the sample in terms of risk. Here again, the Company has failed to present the full picture. I reiterate that Arkla has a PGA that insulates it from gas price fluctuations as much or more than the sample companies. Arkla has a WNA which not all of the sample companies do. Arkla also has a MRP through which it currently recovers $8.9 million annually via a monthly adjustment to rates. The overwhelming majority of Arkla's plant additions (84% in the pro forma year) pass through the MRP. Such a mechanism is not common to the sample. The two sample companies with a similar mechanism receive less timely recovery on a more restricted basis. In conclusion, after considering all of the risk factors affecting Arkla and the risk-comparable sample, I continue to believe my sample analysis is reasonable to utilize in setting Arkla's required cost of capital.

SUMMARY OF RECOMMENDATIONS

Q. Mr. Brown, please summarize your recommendations to the Commission.

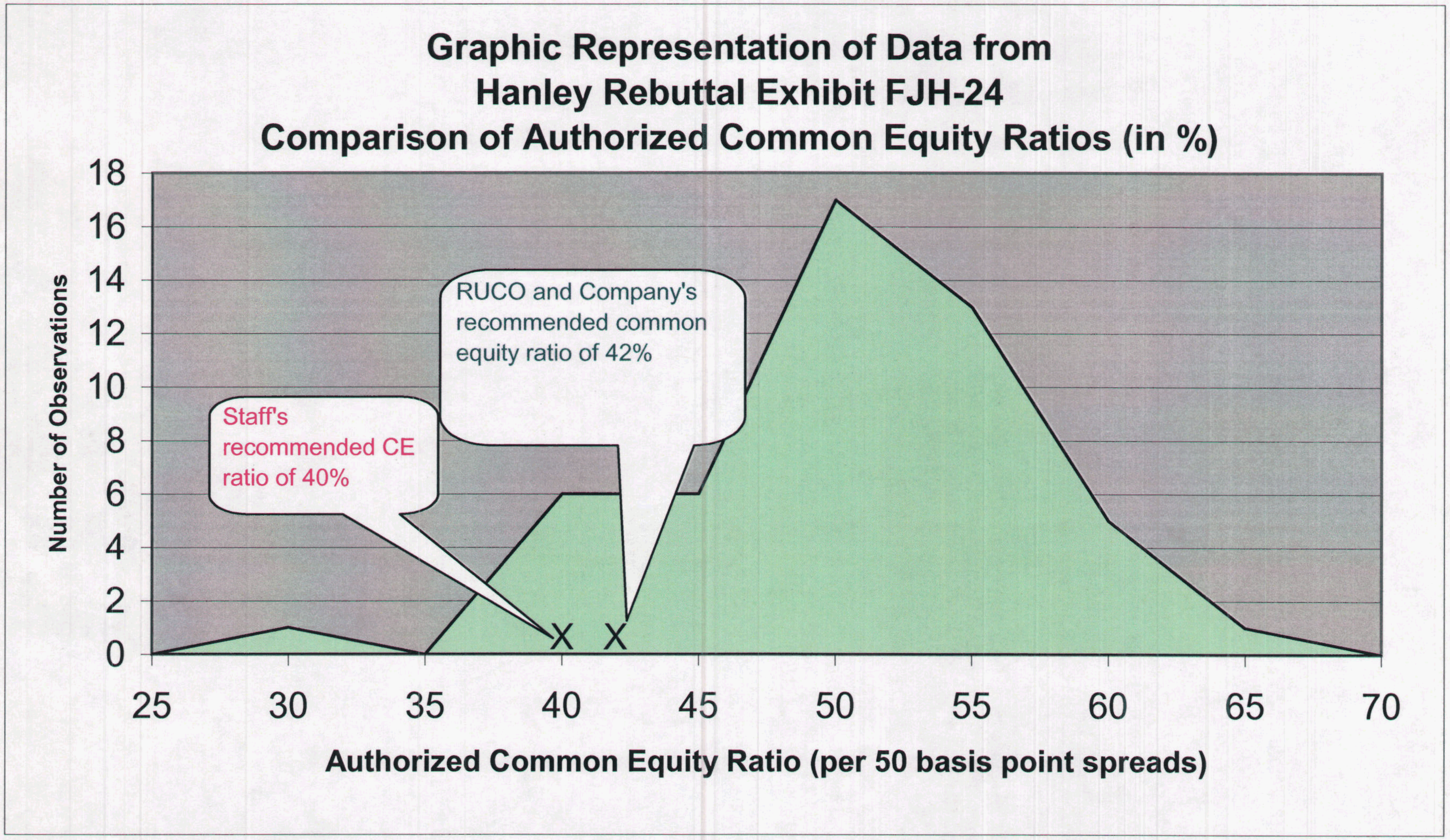
A. I evaluated the Company's request and determined that it has failed to substantiate its exclusion of short-term debt from the capital structure, and its requested return on equity exceeds a reasonable range of required equity returns based on the current market environment. Arkla has failed to establish any deficiency with the MBSA or its application. Further, the Company has rate mechanisms that serve to provide risk reduction benefits. Thus, Arkla also fails to substantiate its argument that it is more risky than the risk-comparable sample utilized by both Dr. Hadaway and myself.

I recommend Arkla be afforded the opportunity to earn an overall return of 5.24%. This return is derived using the various components presented in Surrebuttal Exhibit JB-14. My recommended return reflects a debt-to-equity ratio of 54:46, a 6.54% cost of long-term debt, and a 9.2% cost of common equity. These recommendations consider the current economic climate, consistently apply the sample average methodology, satisfy bond rating agency benchmarks, and compensate Arkla's investors for the risks associated with an investment in an LDC, thus meeting the standards of what constitutes a reasonable rate of return.

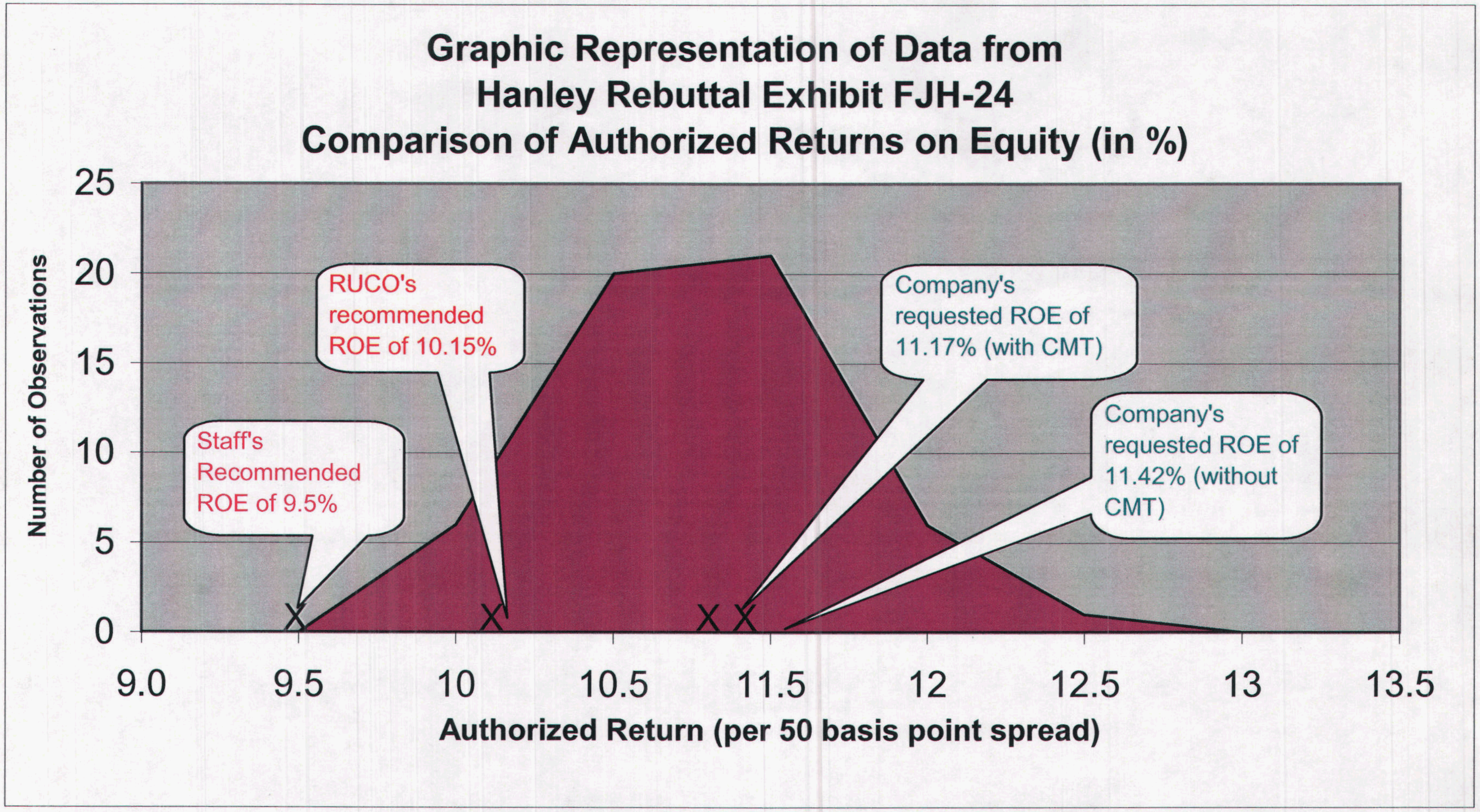
Q. Does this conclude your Surrebuttal Testimony at this time?

A. Yes, it does.

APPENDIX 6


Graphic Representation of Data from
Hanley Rebuttal Exhibit FJH-24
Comparison of Authorized Common Equity Ratios (in %)
Number of Observations
18
16
14
12
10
8
6
4
2
0
25
30
35
40
45
50
55
60
65
70
Authorized Common Equity Ratio (per 50 basis point spreads)
Staff's recommended CE ratio of 40%
RUCO and Company's recommended common equity ratio of 42%
X
X

APPENDIX 7


Graphic Representation of Data from
Hanley Rebuttal Exhibit FJH-24
Comparison of Authorized Returns on Equity (in %)
Number of Observations
25
20
15
10
5
0
Staff's Recommended ROE of 9.5%
RUCO's recommended ROE of 10.15%
Company's requested ROE of 11.17% (with CMT)
Company's requested ROE of 11.42% (without CMT)
9.0
9.5
10
10.5
11.5
12
12.5
13
13.5
Authorized Return (per 50 basis point spread)